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97th Congress }
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COMMITTEE PRINT

UNITED STATES-CHINA ECONOMIC
RELATIONS: A REAPPRAISAL

A WORKSHOP

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(II)

EXECUTIVE SUMMARY

Economic relations between the United States and the People's Republic of China have strengthened and matured since the establishment of unofficial ties a decade ago. Americans have put aside highly speculative and overly optimistic predictions concerning the vast potential of the China Market and are now assessing more soberly the costs and benefits of doing business with China. Following the normalization of United States-People's Republic of China (PRC) diplomatic relations in January 1979, trade has prospered. This has been accompanied by steady efforts by the United States and Chinese Governments to regularize economic and commercial relations across the board.

By 1980 and 1981, China ranked among our 15 most important export markets and was our fifth largest Asian market. For such products as wheat, raw cotton, and manmade fiber, China has become our most important Asian market. China has the potential to supply the United States with significant quantities of important raw materials, notably petroleum, as well as certain light manufactured products.

To foster better economic relations, the United States and Chinese Governments have signed a series of bilateral agreements regulating commerce. China now receives most-favored-nation tariff treatment in the United States as a result of the United States-China Trade Agreement; the Overseas Private Investment Corporation and the Export-Import Bank are now able to do business with China. The United States and China have established a long-term agreement on the sale of American grain to China. And a United States-PRC Consular Convention has been signed and ratified by the United States and China.

Despite these accomplishments, the fact remains that China's immediate economic importance to the United States remains relatively small. China provides a market for only a little more than 1 percent of total U.S. exports. Most exports have been concentrated in agricultural and industrial raw materials. China takes less than one-half of 1 percent of American worldwide machinery and equipment exports. With the single exception of oil drilling equipment, China cannot be considered a major market for U.S. machinery and equipment. The expectations of a few years ago of some American business representatives that China would purchase large amounts of American industrial equipment and technology to assist the Chinese modernization efforts have not materialized. Faced with serious economic and other limitations, China has been compelled to readjust its economy and to cut back on purchases of foreign machinery and technology.

At the same time, the substantial growth of U.S. exports of agricultural and industrial materials to China from 1978 to 1980 now appears—at least temporarily—to be leveling off, clouding prospects for future large increases in American sales of these products to the PRC.

Some Americans claim that the process of regularizing economic and commercial relations has also stalled. They have called upon the U.S. Government to adopt legal, financial, and other measures in order to remove obstacles to the smooth conduct of Sino-American economic relations and to provide greater support for American businesses dealing with China.

Congressional interest in these issues has been strong. Congress plays an important role in oversight of U.S. policy regarding foreign trade and investment. It has played and will continue to play a direct role in changing existing U.S. laws that affect economic interchange with China, and in providing funds for U.S. Government efforts to promote Sino-American trade and investment.

In order to examine thoroughly the current status, likely prospects and major implications of United States-China economic relations, the Senate Foreign Relations Committee requested that the Congressional Research Service join with it to conduct a three-part workshop on these issues. Twelve experts of differing backgrounds and divergent points of view were brought together to examine salient questions about the developing relationship and to offer recommendations for American policy. Each spoke in his individual capacity. The views expressed are not necessarily those of the institutions with which the individuals are affiliated.

- Four focused primarily on developments in China's modernization program and their likely effect on economic ties with the United States;
- Four focused on practical problems Americans have had in doing business with China, and assessed the prospects for success of particular U.S. businesses dealing with China;
- Four focused on what the U.S. Government should be doing, if anything, to further promote United States-China economic ties.

There was general agreement among the participants that opportunities exist to expand trade between the two nations. Americans often have tended toward extremes of optimism or pessimism regarding American economic prospects in China. Participants stressed that the United States should strive for a more realistic and sober balance in assessing the China market. They judged that China was likely to remain of continuing importance to U.S. exporters of agricultural, forestry, and some other basic products; of potentially great importance to American oil exploration companies now actively involved in the search for offshore oil in the South China Sea; and of growing importance to American enterprises interested in establishing compensation trade or other trade arrangements with Chinese counterparts, whereby American expertise and equipment are brought into China to produce goods with Chinese labor primarily for foreign, including United States, markets.

Agreement on these issues was tempered by the assessment that serious difficulties on both the Chinese and U.S. sides would restrict growth in economic cooperation for some time to come. China's general economic readjustment program and shortcomings in transportation, power, energy and other key sectors will likely restrict China's economic development and curb the growth of foreign imports for at least the next several years. Recent Chinese economic reform meas-

ures promise no quick fix for these problems. Also, in the opinion of some, the political atmosphere in China remains fluid, prompting many officials to avoid a firm commitment to recent economic changes, and suggesting that those policies could be altered substantially in the future.

U.S. ability to promote economic relations with China remains limited by the reluctance of the U.S. Government to provide funds for U.S. trade and investment in China at a time of severe American budget retrenchment. It is also slowed by limited tolerance in the United States for major Chinese export items such as textiles and other light manufactured goods. Also, continued American administrative and legal restrictions impede the sale of certain technology and the granting of American aid and other incentives to foster closer United States-China trade. As for the commercial atmosphere, PRC economic relations appear closely linked with our bilateral political relations which undergo periodic stress. The participants noted, for example, that the current United States-PRC difficulties over Taiwan may be reflected in reduced Chinese enthusiasm for doing business with the United States.

Recommendations offered by the group were generally modest, reflecting a judgment that there is little that the U.S. Government can do over the near term to increase in a major way the size and scope of Sino-American economic relations. The recommendations focused on measures designed to end the alleged ambiguity in U.S. Government administrative procedures which reportedly slow the sale of U.S. technology for China; to do away with remaining legal restrictions on American trade and investment in China; and to allow the United States to use modest amounts of financial assistance and other incentives to support American business in China.

Some controversy surrounded proposals to change existing law, mainly the Foreign Assistance Act of 1961, in order to allow for American aid to China. Some participants urged that the current legal barrier should be dropped in order to show American good intentions toward China and to open the possibility at a later date of limited U.S. Government financial support for American companies trying to compete with foreign firms, who are supported by their governments' aid and economic incentive programs in China. Others advised that in the absence of a clearly defined and carefully limited proposal for U.S. Government aid to China, any effort to change existing law could become a highly symbolic and controversial issue in the Congress that might be defeated.

The four participants tasked specifically with assessing China's modernization programs and their implications for the United States highlighted major internal Chinese difficulties that are likely to impede sustained PRC economic growth over the next decade. China's economic readjustment, in effect since 1979, will probably continue to limit overall economic performance until it succeeds in modifying the serious contradictions and bottlenecks that developed in the Chinese economy during the previous 20 years. Recent economic reform measures promise no easy solution to China's difficulties as they frequently have led to such negative side effects as excessive Government spending and inflation, causing Chinese officials to make repeated adjustments in

how reform measures are implemented. The resulting uncertainty over economic policy has been compounded by political indecisiveness on the part of many middle and lower level Chinese officials who remain unclear about the stability of current policy directions and the orientation of China's leaders. As a result, they have avoided fully committing themselves to the announced policies of top-level officials like Vice Chairman Deng Xiaoping, who complains that his programs are being undercut by China's massive and unresponsive bureaucracy.

One participant judged that China's agricultural sector was making considerable progress under recent reform efforts and advised that this may reduce somewhat China's interest in purchasing U.S. agricultural products. Another noted that China's energy problem may soon take a turn for the worse, noting a recent World Bank study which projected that China's demand for oil and other energy commodities may soon outstrip production—a prospect which could redound to U.S. benefit by increasing Chinese interest in cooperating closely with U.S. companies in order to develop expeditiously Chinese offshore oil and other energy sources.

The participants dealing with practical issues involved in conducting business with China noted that the PRC was often a difficult market to penetrate. Success required a substantial commitment of the American side's management and technical time and expertise before an agreement was concluded. Recent Chinese policy changes decentralizing foreign trade decisionmaking, establishing many new kinds of transactions for doing business with foreigners and adjusting Chinese laws dealing with investment and trade, have further complicated American interaction with the PRC. However, successful American experience with China continues to grow as American companies learn where the market for their product is in China, and how to reach it.

American companies were said to be judged by the Chinese on the basis of how well their work program met Chinese needs, the technical and financial ability of the American company to carry out the work program, and the overall credibility of the American company in following through with past commitments in China and elsewhere. While the Chinese were said to dislike legalisms and long contracts favored by U.S. firms, American companies reportedly have been able to secure sufficient legal safeguards in contracts with the Chinese.

The participants tasked with offering recommendations for U.S. policy made suggestions designed to ease the flow of U.S. technology to China, to remove remaining legal restrictions on economic ties with China, and to promote American business interests in China more actively by such means as U.S. Government loans or aid. Some judged that there was a need for specific American agreements with China to assist U.S. companies in avoiding being taxed twice on their profits from China, and to safeguard U.S. patents and copyrights. American Government representatives were requested to be more firm in asking for better treatment of U.S. business representatives in China, and to be more aggressive in collecting information of use to American businesses in the PRC. Other suggestions included a call for passage of U.S. legislation allowing for formation of large American trading companies—a form of enterprise said to be particularly well suited for dealing with foreign competitors in China; the negotiation of a

long-term United States-PRC trade accord that would provide a framework for future bilateral economic cooperation; and the establishment of a system of safeguards that would allow the United States to pull back from certain economic interaction with China in the event that such interchange were no longer thought to be in the U.S. national interest.

The case was made that closer American cooperation with China would not pose a major economic problem for such longstanding American business partners in East Asia as South Korea, Taiwan, Hong Kong, and the non-Communist countries of Southeast Asia. Those dynamic and highly resilient economies are expected to move into the production of more sophisticated goods as they face competition from the relatively unsophisticated manufactured commodities from the PRC.

Sino-American political relations, particularly the current difficulty over Taiwan, overshadowed all the recommendations. Though they steered clear of specific suggestions as to how the United States should handle the United States-PRC-Taiwan question, the participants noted that if disagreements about Taiwan lead to political difficulties between the United States and China, they expect to see a decline in United States-China economic relations. Conversely, a resolution of this problem satisfactory to both the United States and the PRC would presumably open the way to some improved bilateral economic ties.

It seems clear from the proceedings of the workshop that the United States has important economic interests that complement U.S. political and strategic concerns in developing relations with China. United States-China economic ties are worth pursuing and warrant Government support, wherever feasible. But the United States should strive to keep the likely benefits of these economic ties in the proper perspective of our overall foreign policy interests. Avoiding extremes of euphoria or pessimism, American officials should continuously reassess the changing situation in China, look for ways in which we can encourage potentially promising areas of economic interchange, while remaining aware that there are limitations involved in a dramatically expanding American economic relationship with China.

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UNITED STATES-CHINA ECONOMIC RELATIONS: A REAPPRAISAL

WEDNESDAY, FEBRUARY 24, 1982

UNITED STATES SENATE,
COMMITTEE ON FOREIGN RELATIONS
AND THE CONGRESSIONAL RESEARCH SERVICE,
Washington, D.C.

The workshop convened, pursuant to notice, at 9:33 a.m., in room S-207, the Capitol, Senator S. I. Hayakawa (chairman of the Subcommittee on East Asian and Pacific Affairs of the Senate Committee on Foreign Relations) presiding.

Senators present: Senators Percy, Hayakawa, and Glenn.

I. CHINA'S PROSPECTS AND IMPLICATIONS FOR THE UNITED STATES

Senator HAYAKAWA. Good morning. I am happy to welcome all of you to this workshop on United States-China Economic Relations, which is being jointly sponsored by the Congressional Research Service and the Senate Committee on Foreign Relations.

As you may be aware, this meeting is a sequel to the one held last October on the Implications of United States-China Military Cooperation. That workshop was a most interesting experience for me.

As many of you may be aware, I am a longtime supporter of Taiwan. It has taken me a while to make the adjustments required by our new relationship with the People's Republic of China [PRC]. Frankly, I am still troubled by many aspects of the United States-China-Taiwan relationship, of which the current furor over the administration's handling of plane sales to Taiwan is the latest example.

Therefore, I was somewhat surprised to learn in the previous workshop that there was a consensus that United States-China military cooperation would be in the national interest of both nations. I am curious to learn whether the same identity of views will emerge from your discussions on economic relations between the United States and the PRC.

I note that the subject matter title of the workshop, United States-China Economic Relations, is followed by the words, "A Reappraisal." This word would imply that the recent history of our economic relations has not been totally satisfactory, or has not developed as expected, at least in the minds of some.

I imagine that this feeling reflects the contrast between the euphoria which gripped many American businessmen and economists at the time of the normalization, and the subsequent realization of the realities of the United States-China trade and investment as they emerged

until today. The lure of the China market of the past as exemplified in the 19th century slogan, "Oil for the lamps of China," has been replaced by visions of a pocket computer for every Chinese businessman, a tractor for every Chinese farmer, a food processor for every Chinese housewife, and a Rubick's cube for every Chinese teenager. But are today's prospects really any better than the old? Many businessmen, after hard experience, think not, and no one can deny the attraction of the billion-person market, but with China's \$250 per capita income, perhaps market estimates should emphasize purchasing power as well as numbers.

The same caution might well be exercised as regards foreign investment. We have all heard of China's cancellation or postponement of large-scale industrial projects involving foreign capital and expertise. It seems clear that China's appetite for modernization may well be out-running its capacity for planning, administering, and especially funding major endeavors. The lessons have been painful, especially for the Japanese, and I am not sure to what extent the U.S. Government should encourage U.S. firms to plunge in where the risks are obviously great. The related question of the quantity and the level of technology transfer also concerns me.

Another aspect of China's economic development which concerns me is its export industry. That is, what effect will cheap Chinese textiles, electronics, and small manufactured products have on the markets of Korea, Taiwan, and the ASEAN countries, which are well developed in these areas. After years of foreign aid and cooperative trading relationships with these and other friends and allies, I would hate to see China stealing their markets. At the very least, I would not want the United States assistance in that process.

Overall, I am also concerned about the political ramifications of closer economic relations between the United States and China. I would like to make certain that such ties are in the best interests of the United States and its friends and allies. We should consult closely with Japan. As most ASEAN states have a latent fear of Chinese expansionism, and this is clear when you visit the ASEAN nations, we should avoid any action which would threaten their economic development or security.

From the foregoing remarks, you can discern that I have some reservations about the substance and the appropriate direction of the United States-China economic relations. At the same time, I recognize that we are now in a new era, and that China's potential for the American businessman and investor should be carefully explored.

I am grateful, therefore, for this opportunity to join with the experts in this room in this exploration of future possibilities. Perhaps I shall find that my fears and misgivings are groundless. I hope so. In any case, I do hope that your deliberations will be fruitful. Thank you.

Mr. SUTTER. Thank you very much, Senator.

We will now proceed with the formal presentations for this morning's session. I would like to make a brief statement, first of all. The U.S. Government officials who are participating in our workshop are doing so representing only themselves; they do not represent any official U.S. Government position regarding United States-China issues or Chinese developments.

With that, I would like to introduce our first speaker, Prof. Robert Dernberger, from the University of Michigan. Professor Dernberger was educated at the University of Michigan and at Harvard University. He is professor of economics at the University of Michigan. He also has served at the economics department of the University of Chicago. Professor Dernberger has traveled extensively in China, and has been a member of three official delegations there. His publications are widely known, particularly to us here in the Congress, for his excellent contributions to the volumes of the Joint Economic Committee on the Chinese economy.

Professor Dernberger, please.

STATEMENT OF ROBERT F. DERNBURGER, PROFESSOR OF ECONOMICS, UNIVERSITY OF MICHIGAN, ANN ARBOR, MICH.

Mr. DERNBURGER. When my secretary gave me my paper Friday to put into the mail, I suddenly discovered that it was far too long for this purpose, and spent the weekend revising it and cutting it in half, and that is the paper that you have in front of you, or I hope you have it in front of you.

Last night I prepared remarks for about 20 minutes, and now I am told I have 10 minutes. So if we keep going, I might get to the position where I didn't even have to come, I guess. [General laughter.]

But in any event, I really will try to summarize the main arguments, so as to put them on the table, at least, for discussion. The paper is devoted to the economic reform program of the past several years in China and its likely prospects. I really want to ask the questions, why the economic reform program, what are its characteristics, what success has it had, and what are its likely future prospects for guiding China's economic development?

Let me quickly say that for brevity, I refer to the post-Mao leadership in the paper without getting into the problem of what the particular leadership coalition is at any time, and who is advocating what reforms against what other groups. That is a very important problem, but I am studying the economics of it, and I just can't deal with that in this brief paper. The political issues involved, I hope, are emphasized in the paper, but these remarks are really on the economics of the reform program, and not on who the particular people are who are advocating it.

Also, I do not go into the history of the reform and trace its origins back to the 1950's and 1960's. Dorothy Solinger has done that in an article in *Asian Survey*.

Another very serious problem that might be misunderstood is my use of the term "economic reform program" for policies which, quite unlike the economic reform programs of Yugoslavia and Hungary, do not constitute a single package or are introduced as a single package. The Chinese economic reform program consists of reforms, institutional changes, and policy changes introduced and advocated by particular people at particular times to address particular problems. It is the evolution of these policy changes that we now ex-post look back on and call the Chinese economic reform program. It is still in the process of evolution.

Let me get on with it. Why was it introduced? The argument that I try and make—and I can merely restate it here—is, Mao would have had to introduce an economic reform program even if he had stayed in power. The economic problems emerging as a result of the economic development model they were using were very serious problems that would have led to a cessation of continuous self-sustained growth.

I am referring to the serious economic bottlenecks in the economy, the failure of the standard of living to increase, and the long-run steady transition of China's foreign trade pattern from a major agricultural exporter toward the point of being an agricultural importer. The trend certainly was in that direction, and in the midseventies China was importing many of its traditional comparative advantage agricultural products.

Those problems, I believe—and as I try to show in the paper—can be traced to the development model they had been using. That development model included a Soviet economic system which they had borrowed lock, stock, and barrel from the Soviet Union in the fifties and which still continues as China's economic system today. I see no arguments in the economic reform that calls for the replacement of that economic system by a different economic system. Rather, the reforms call for the modification of that economic system.

A second element in the traditional Chinese development strategy was the Stalinist "big push" development strategy—a very high rate of accumulation, and the allocation of that accumulation in favor of the heavy industries, especially the basic metals and machine-building industry.

The third element in China's traditional development model, and the one that makes it unique, are the Maoist economic principles, such as self-sufficiency and normative incentives. One could go down a lengthy list, which I don't have time to do here. When I say the Maoist economic principles, I am referring specifically to the way they were made operational by his radical followers in determining economic policy in China. In any event, this economic development model was leading to very serious problems, economic problems, and any leadership group in China during the last half of the seventies would have had to introduce economic reforms to deal with these problems.

The characteristics of the economic reform, I believe, follow on what I have just said. They have been a complete rejection of the Maoist economic principles. They have been a rejection of the Stalinist "big push" development strategy in favor of balanced growth, and they have included a reform of the economic system to introduce—to supplement or add to the traditional Soviet economic system—a greater role for market forces, a market sector, private economic activity, and decentralized decisionmaking. However, the Soviet economic system of centralized planning and resource allocation continues as the major determinant of resource allocation in China.

What are the results that they have had from this attempt to introduce these reforms? I believe everyone—well, I believe most—would agree that the rapid growth of 1977 and 1978 is a recovery from the midseventies and cannot be attributed to these reforms. The results of the reforms are really determinable in 1979 through 1980 and somewhat into 1981. During that period, growth declined, largely due to

the very significant decline of growth of heavy industry, until last year it was negative, a negative 4.5 percent. Light industry grew above 10 percent in those years. Agriculture did very well in 1979 but has not done so well in 1980 and 1981, not because of the reform so much but because of bad weather.

These macro results, however, are the intended results of the reform. They intended to reduce the rate of growth by trying to lower the rate of accumulation and restructure the economy, and that is what is happening here. The reforms, however, did not eliminate the bottleneck sectors that they had to deal with, energy, transportation, and I could go down the list. As I tried to show in my paper, the economic reforms they have introduced either have failed to solve these bottleneck problems or have actually aggravated the problem, especially systemic reforms that have been introduced. The major problem with the economic reforms, however, is not this failure to solve the bottleneck problems. It is not going to be easy to solve those problems and can only be solved in the long run.

The real problem with the economic reforms, and I hope I show this in the paper, is, they have lead directly to the very large budget deficits, inflation, unemployment, and import surpluses that occurred in these 2 years and were not caused by the traditional development model. These were entirely new problems. Now, if most Western governments had any one of those on its hands, it would have trouble. The Chinese had all four of them, and in major proportions, in 1979 and 1980.

I am sorry I don't have time to show why these reforms led to that result, but I think it can be shown quite easily.

Now, the Chinese did not sit by after introducing a reform program and let these problems happen and not react to them. They have reacted to them, and in the manner in which they have reacted to them, I think we can see something about the fate of the economic reform program.

In the spring of 1981, when they found that the results for 1980 were even worse than they had thought they would be in the fall of 1980, they immediately introduced a recentralization of control over the economy, putting the reform of the economic system back on the shelf, while strengthening the traditional centralized control of the Soviet economic system; control over foreign exchange and foreign trade, control over investment activities, control over wages, control over prices, i.e., a considerable attempt to recentralize the economy and negate the purpose or at least put on hold some of the reform program.

I would like to draw your attention to Zhao Ziyang's speech in December. It is one of the most interesting speeches I have read in the last 30 years in reading speeches from China. It is a report on the work of the government. It begins with economics—it is a very lengthy speech—it sticks with economics, and ends with economics, and it lays out, I believe, pretty clearly the thinking in China, at least in the State Council, on how to deal with their various economic problems.

In the section on reform of the economic system, he changes his positive arguments and his tone and saying only that we have to

study these reforms and verify their results, with the intent of drawing up a long-run plan to be introduced some time into the future. Then, not referring to the State Council as having made any decision, he says, my opinions are, and lists his own opinions.

In the other part of the speech, he is much more concrete about what must be done.

I am sorry to be rushing so, but I am sure Bob will cut me off in a minute.

What about the future prospects of this reform program and its chances for success? On the rejection of the Maoist economic principles, I believe we can already see the trend to modify those alternatives being advanced by the right wing of the party, or Deng and his followers. The open economy has been modified considerably. The specialization in agriculture has been modified considerably to emphasize grain as a key link. I think what we will see evolving out of this is a mix or a constraint on the right-wing economic principles that are guiding their economic policy at the present time; a constraint that prevents them from being carried out to excess in terms of open economy, unequal income distribution, and so on.

I would argue that that is what Mao meant to achieve all along. The radicals, in making his principles operational, really did more harm than good to his economic principles.

The second aspect of the reform program, the rejection of the Stalinist "big push" development strategy, I believe, was necessitated by economic reality. They had to reject the "big push" development strategy. It simply wouldn't work any longer. They had to restore equilibrium and balance the economy before sustained growth could be resumed. The balancing of the economy is estimated to take through the rest of the eighties, and it will be the 1990's before the Chinese can resume rapid self-sustained growth. What happens when the economy is balanced again? Will they continue along a balanced growth path, or will they revert to the traditional Stalinist "big push;" high rates of accumulation, with emphasis on heavy industry and so on?

To be brief, and you can read my paper, my bet is on the Stalinist planners. The Soviet economic system was developed for the specific purpose of carrying out a "big push" development policy. It does a horrible job in attempting to achieve a balanced growth strategy. In fact, one could say they might even be a contradiction in terms.

Furthermore, if you want to pursue balanced growth, almost any other economic system that is known does a better job than the Soviet economic system. It is in recognition of this that the Chinese, as part of their economic reforms, did attempt to modify the Soviet economic system to make it more amenable to a balanced growth economic strategy.

But what about the success of their attempts to modify the Soviet economic system? I would say there are three major problems here. Reforms of the Soviet economic system take an awfully long time. Ask the Hungarians and the Yugoslavs. You have to have the guts to stick with it for 10 or 15 years. You can't try it out for a couple of years and say, well, there are several economic problems associated with this, so we will go back to central controls and our old system that we can rely upon.

The Yugoslavs and Hungarians are still sticking with it, despite many serious economic problems. The Chinese tried it out for 2 years, and quickly reinstituted central controls. Furthermore, the reinstitution of central controls did bring their budget deficit, import surpluses, unemployment, and inflation under control and greatly reduced these problems. That is a lesson that is not going to be lost on the Chinese leaders when the reforms generate economic problems.

There are two other problems. One, which is admitted by Deng Xiaoping and his followers, is the bureaucracy. It is all right to have a new leadership at the top that is wholeheartedly behind the reforms and wise in its choices and its policy decisions, but it is another thing to have those policies implemented at the lowest level. They now admit that they have had considerable resistance to these reform policies, not just because of the Maoists at the lowest level, but because of the Stalinist bureaucrats. There were a lot of those in China, those who lived and worked within that system for 15 or 20 years.

Also, there are local level bureaucrats who have heard it before, treating this as yet another reform program that in 4 years will be rejected, and then they will have their necks on the chopping block. They give lip service to the reform and really don't do much. Also, there are those that are incompetent and simply do not know how to administer the economy except in the way they had done it all along, and the introduction of these new methods and basis of decisionmaking is too difficult for them to carry out.

Deng Xiaoping and the other leaders say they are going to weed these people out of the bureaucracy and the party and replace them with people who are more loyal to their policies and more able to carry them out. This is going to take a long time, and will be a very difficult job. I for one believe the odds against their being successful are very great.

The other obstacle is price reform. Economic reforms don't work unless you reform prices, and in this regard the Chinese really are up against an obstacle. Nobody has figured out how you reform prices. The Czechs, the Hungarians, and others have used a computer system with linear programming models and so forth to approximate shadow prices, but how do you estimate scarcity prices when you don't have markets? You can borrow world prices, but China is too large an economy, and is not that involved in foreign trade to use the world's prices to approximate their own scarcity prices.

Well, let's assume they knew how to estimate these prices. Who has the guts to do it? They have used prices for the last 20 years to determine income distribution, not distribute or allocate resources; that is, determine the incomes of the individual, occupation, region, level of government, and so forth. With the distribution of income dependent upon their prices, a price reform is going to result in a tremendous redistribution of income in the economy.

This is admitted by Xue Mugiao, who says we can't start with price reform, we have to start with wage reform. Well, we have heard that before, and observe attempts to reform wages throughout the socialist world and they have ended up. That would take all of Deng Xiaoping's political clout to even try to bring it off.

In short, I am very pessimistic about the future fate of the reform, but the development model of the future will be better than that of the past, because it will contain a mix of Maoist and right-wing economic principles. It will modify the Stalinist "big push" development strategy to be more in keeping with the reality of China's economy, and it will lead to some modification of the traditional Soviet economic system, although it will not go as far as the reform would like it to go. With that new economic model, I see no reason why sustained growth cannot be resumed in the 1990's and that they cannot eventually achieve the modernization of the Chinese economy. Thank you.

[Mr. Dernberger's prepared statement follows:]

PREPARED STATEMENT OF ROBERT F. DERNBERGER

One prominent student of Chinese politics has identified the 3rd Plenum of the 11th Central Committee of the Chinese Communist Party in December of 1979 as the most important turning point in Chinese politics since the May 4th Movement in 1919; the Chinese Communist Party judges the 3rd Plenum as being the most important turning point in the history of the Party since the founding of the People's Republic in 1949. As is true of any turning point in history, the debates and decisions at the 3rd Plenum summarized and focused the gathering forces which preceded it and served to strengthen those forces in influencing the events which followed. The transition of China's political leadership and economic policies from the domination of the more radical followers of Mao in 1976 to Deng Xiaoping and his more pragmatic modernizers in 1980 was neither smooth nor continuous. In the Spring of 1978, Hua Guofeng had confidently released the Ten Year Plan for China's Modernization, but the planned output and input targets of the 10 Year Plan proved to be infeasible and inconsistent even by the end of 1978. The draft reform proposal for correcting the "sad state of unbalance" presented at the 3rd Plenum ran into considerable opposition and the debates at the Plenum, we are told, were very heated. That debate clearly aligned the followers of Mao, led by Hua Guofeng, against the followers of Deng Xiaoping. Although the draft proposals put forward by Deng and his followers at the 3rd Plenum were not formally adopted as national policy until the Summer of 1979 and Hua Guofeng and other supporters of Mao were not removed from their positions in the Government and Party until 1980 and 1981, the pendulum was clearly swinging in favor of Deng and his followers as a result of the 3rd Plenum. This transition in political leadership and economic policies over the past 4 years, of course, was accompanied by an almost continuous introduction of economic, institutional and policy changes which we now summarily refer to as China's economic reform program.

My purpose here is to specify the reasons for the economic reform program, to summarize its basic ingredients, to review its results thus far, and to suggest the prospects for its success in the future. There are several important qualifications to the arguments that follow. Politics and political coalitions in the leadership are important explanatory variables in China's economic development strategy and policies, but my analysis and arguments are largely restricted to economic issues. Thus, I am much less concerned with who the reform advocates are, than with the reform they are proposing. Nonetheless, the discussion should make clear that I regard political developments as important as the purely economic considerations in determining the success of China's economic reform program.

Second, I do not propose to spell out the details of the individual economic, institutional and policy changes that have been adopted over the past 4 years, nor to trace their origins to similar proposals or policies advocated or adopted earlier in the history of the People's Republic of China. Fortunately, I can refer the reader to a more detailed analysis of the individual policies and institutional changes in the economic reform program and their chronological evolution that I have written for the forthcoming volume "China Under the Four Modernizations," soon to be issued by the Joint Economic Committee, U.S. Congress. For the historical origins of the individual policy and institutional changes in the economic reform program, I can refer the reader to Dorothy S. Solinger's paper, "Economic Reform vs. Reformulation in China: Where Do Rightist Ideas Come From?", published in *Asian Survey* (September 1981).

Despite these caveats, the attempt to treat the many economic policy changes of the past 4 years as an economic reform "program" so as to summarize the main features, consequences, and possible future results of these reforms may well lead to a complete misunderstanding of my argument. The particular institutional and policy changes introduced over the past 4 years were proposed by particular groups to deal with particular problems in particular sectors at a particular time. Some of these proposals were never adopted; some were adopted, but never implemented; some were tried out as experiments; and some were modified or revoked as their consequences or new economic problems emerged. Nothing could be further from the truth than to picture the individual institutional and policy changes over the past 4 years as but the pieces of an integrated and consistent master plan that Deng and his followers have proceeded to implement as they regained control over economic policy following the death of Mao.

In his study of economic theory in China, Cyril Lin argues that a basic objective of the reformers is to determine the objectives and principles for an economy in the transition stage from capitalism to communism, i.e., a socialist economy; in the realm of theory, to derive the objective economic laws of socialism. Once these economic laws of socialism are determined, then proper institutions and policies can be adopted on the basis of these laws to achieve economic modernization and true socialism. As Lin argues, the Chinese have proceeded to introduce institutional and policy changes before they have worked out the theoretical basis for these reforms. In other words, these institutions and policies are ad hoc reactions to particular economic problems and are not the individual parts of a master plan for the economic modernization of China's economy. I also agree with Lin when he argues this is an optimistic interpretation of the economic reform program, because if a master plan does lie behind the various institutional and policy changes, the infeasibility and inconsistency of some of the changes would indicate the master plan is also inconsistent and infeasible.

When we refer to the Chinese economic reform program in this paper we are explicitly referring to the process of policy experiments in the search for achieving the sustained economic modernization of China's economy, not a fixed and given package of institutional and policy changes. This process has been unfolding over the past 4 years and is likely to continue throughout the decade of the 1980's.

I.

We can begin by asking why these economic reforms were introduced. The easy answer, of course, is to cite—as is commonly done—the history of the two-line-struggle or the basic disagreement over the appropriate economic development model, strategy, and policies over the past three decades. When Mao died and the Gang of Four were overthrown at the end of 1976, Deng Xiaoping and other surviving leaders of the right wing regained power and have proceeded to adopt and implement the development model they had been advocating throughout the two line struggle. This answer is too simple. It does not explain the basic reasons for the current economic reform program and cannot explain the specific timing and characteristics of the individual institutional and policy changes that have been adopted over the past 4 years. Whatever the political or historical explanations of the current economic reform program, the reforms being adopted are the purpose of solving China's current economic problems and the success or failure of the reform program will be mainly influenced by their success or failure in solving those problems.

The economic development model the Chinese had relied upon before the mid-1970's had become serious obstacles to the further sustained modernization of China's economy. Thus, any serious and responsible coalition of leaders—whatever their position in the two line struggle—would have found it necessary to introduce economic, institutional and policy changes to solve these problems. Some would argue that there was no unique traditional Chinese development model which remained fixed continuously over the past three decades. But that is not essential to my analysis of the economic reform program. The economic reform program of the past ten years can best be interpreted as the attempt by Deng and his followers to solve the serious economic problems they inherited when they regained power after 1976 and these economic problems were caused, in large part, by the development model in force at that time.

The development model the post-Mao leadership inherited consisted of three major elements: the Soviet economic system, the Stalinist development strategy, and Maoist economic principles. The basic ingredient in this trinity is the Soviet

model, or the economic system itself. The Chinese directly borrowed this economic system from the Soviet Union in the mid-1950's and it has remained as China's economic system ever since. In the industrial sector the means of production are nationalized and run by public managers who are assigned production targets by the state. These and other targets are determined by a bureaucratic planning administration. In agriculture, production is collectivized and the collectives are assigned plans for cropping, yields, and delivery quotas for sales to the state. Trade, that is, the purchase and distribution of key commodities including all producer's goods and most major agricultural products and all foreign trade, is monopolized by the state's trading agencies under a unified supply plan. Public finance is also unified in the state's budget, with the profits of state enterprises being collected as budget revenue and allocated as unilateral grants for investment projects or as subsidies to cover losses incurred by state enterprises. Prices are set by the state and workers are hired by the state's labor bureaus and assigned to factories where they are paid wages set by the state. To cope with problems particular to the Chinese economy, the Chinese version of the Soviet model includes the rationing of basic consumer necessities and strict control over migration within the country.

This economic system, as it was designed to do, places tremendous control over the mobilization and allocation of resources and outputs in the hands of the central planners. The Stalinist development strategy of unbalanced growth places a high priority on the rapid accumulation of capital and the allocation of a large share of that capital to achieve rapid growth rates in heavy industrial production, especially the basic metals and machine-building industries. Growth in these sectors are promoted as the expense of investments in agricultural development, the light industries, increases in the standards of living, or in the provision of social overhead capital. Arguments and empirical evidence presented in the Chinese press over the past few years show the Chinese have pursued the Stalinist development strategy, i.e., unbalanced growth, over the quarter century before the death of Mao.

It is the third element which makes the traditional Chinese development model unique: the Maoist economic principles. The extent to which the Maoist economic principles were an operational feature of the Chinese development model varied considerably over time and among regions, but these principles were an integral part of the development model the post-Mao leadership inherited from the past. The Maoist economic principles included: (a) self-sufficiency, with limited dependence on inter-regional or foreign trade and assistance, (b) egalitarianism and normative incentives, including mass campaigns, (c) the elimination of the "vestiges" of capitalism or the elimination of private income earning activities outside the socialist sector, (d) participation of the masses in decisionmaking and the elimination of an explicit hierarchy of authority and responsibility based outside the socialist sector, (d) participation of the masses in decision-making behavioral rules and policy determination with reduced emphasis placed on economic rationality, defined as economic costs and benefit calculations. Any description of China's development model and strategy in the mid-1970's would have to include a combination of the Soviet model, the Stalinist development strategy, and the Maoist economic principles, as defined above.

The post-Mao leadership faced several serious economic problems when they came to power: problems which can only be traced to their development model and strategy. These major economic problems were due to fundamental, long-run changes that had been occurring in China's economic development over the past decade or more. For example, the Soviet model enabled the planners to achieve excessive rates of accumulation and the Chinese planners had exercised their ability to do so, the rate of accumulation being over 30 percent in most years. In addition, the Stalinist strategy called for the allocation of this accumulation in favor of investment in heavy industry and, within heavy industry, to specific key sectors such as basic metals and machine building, while depreciating the priority given to investment in other sectors, such as transportation, energy, consumer's goods industries, agriculture, and social overhead capital. Without a market system or any other system to provide the necessary forces to correct for the resulting imbalances being generated in the economy, by the mid-1970's these imbalances had grown to the point where continued sustained growth was most difficult, if not impossible, despite the very high level of accumulation.

Transportation and energy bottlenecks were leading to plant closures for lack of inputs; while the average length of time required for completing capital con-

struction projects was growing longer and longer. Due to the excessive rate of accumulation and the failure to develop the production of consumer goods, the per capita standard of living of the peasants had not increased significantly between the mid-1950's and the mid-1970's. While the urban households fared somewhat better, they did so only because of the increase in workers per household, i.e., fewer dependents per worker. The average wage per worker was not increasing and the list of basic necessities being allocated by rations was increasing over time.

The growing shortage of agricultural products was compounded by the Maoist principles, especially the stressing of self-sufficiency and the attacks on the vestiges of capitalism. The rejection of local comparative advantage in production and stress on grain production forced the peasants to shift land from commercial and cash crops in favor of grain. Given the administered price structure this shift from commercial and cash crops, i.e., more profitable activities, to the production of grain, a low profit crop, reduced the peasants' income earning possibilities and to achieve the grain output targets required a significant increase in labor inputs, as well as purchased inputs per unit of output. Thus, agriculture was becoming a less profitable endeavor and the productivity of labor was declining in real terms. At the same time, the attempt to eliminate private plots and sideline activities and rural free markets had removed this source for supplementing the peasants income from the collective. With peasant initiative being relied upon for developing agriculture, the incentives being provided the Chinese peasants were unlikely to achieve this necessary condition for China's modernization.

These problems in the development of China's agriculture also created problems in China's foreign trade sector. China's export trade is dominated by raw and processed agricultural products and the success of the traditional Chinese model depended upon the maintenance of these exports to finance necessary capital goods and technology imports for industrial development. The failure to achieve a sufficient rate of growth in agricultural production, especially in commercial and cash crops, has led to the steady erosion of China's traditional position as a net exporter of agricultural crops. China now must import considerable quantities of grain to fulfill the needs of urban consumption. As for commercial and cash crop commodities, not only has the absolute level of their export declined over time, but China must now import some of these commodities.

The above long-run economic problems—a badly unbalanced economic structure, lack of growth in the standard of living, and steady erosion of China's comparative advantage in foreign trade—could be corrected by reform of the Stalinist strategy in favor of balanced growth and by rejecting the Maoist principles in favor of proper incentives, greater specialization in production, and allowing some scope for private income earning activities, while retaining the Soviet economic system. This appears to be the argument of those Chinese who now cite the First Five-Year Plan period as a sort of golden age. Nonetheless, all of the above problems were compounded by many problems associated with the Soviet economic system itself. Western observers, and socialist economists and officials as well, have provided us with a voluminous literature exposing the inefficiencies and wastes associated with this economic system. Articles in the Chinese press present the empirical evidence to show these same inefficiencies and wastes have plagued the Chinese economy: Growing stocks of unwanted goods; the failure of the planned balance of supply and demand to reflect actual time, place, and item specific supply and demand; the inability of the local level to use its own initiative to solve these problems due to the bureaucratic administrative nature of decisionmaking, the lack of incentives for doing so, and the inability to do so due to the irrationality of the existing price structure; the lack of technological innovation at the enterprise level; etc. For quantitative measures of these inefficiencies in China's economy, we cite the large share of enterprises operating at a loss over a long period, declining average profit rates, declining total factor productivity, or increasing real costs per unit of output. Not only does the evidence show these problems of inefficiency and wastes existed in China's economy but that they were growing more serious over time.

The above discussion should be sufficient to explain why any post-Mao leadership coalition could not stick with the traditional Chinese development model and strategy; an economic reform program was increasingly becoming a necessity dictated by economic reality.

II.

The portion of the economic reform program most predictable solely on the basis of political factors was the reform of the Maoist economic principles. When Deng and his followers regained power after the death of Mao they were quick to blame the economic problems they inherited upon the Maoist economic principles, or at least the way they had been made operational and implemented by Mao's more radical followers. This rejection of the Maoist economic principles has become official policy and this portion of the economic reform program is the most sweeping and complete change in the traditional Chinese development model and strategy that has been introduced and carried out thus far.

Self-sufficiency remains as a long run objective, but extreme attempts to achieve self-sufficiency within the unit of production, the local area, and internationally has been rejected in favor of greater specialization based on comparative advantage. As for egalitarianism, normative incentives, and mass campaigns, these have not only been rejected, but the extent to which the post-Mao leadership has switched to a reliance on material incentives to achieve increases in productivity and output is truly remarkable. Prices paid to the peasants for most agriculture were increased significantly while in the industrial sector, workers received significant wage increases, promotions and bonuses, and piece rate systems have been reintroduced. For the enterprises, there are higher rates of profit sharing and local units of government are able to keep a larger share of the revenues they raise.

Perhaps the most important change from the viewpoint of the energetic and innovative Chinese peasant, however, is the negation of the Maoist attack on the vestiges of capitalism. Private plots, side line activities, and rural trade fairs (free markets) in the rural areas, as well as collective and individual or household private enterprise in the urban areas, are not only allowed, but encouraged. The Chinese have reacted to these private income earning opportunities with a vengeance.

Mao's economic principle of putting the masses in control at the expense of an economic administrative bureaucracy with well defined roles of authority and responsibility to be staffed by those with the requisite skills has been rejected for the sake of greater efficiency and productivity. Revolutionary committees have been disbanded and universities reopened to students selected on the basis of entrance exams. In the factories, the Party has been told to "stand aside" and allow the manager to manage. On the other hand, it could be argued that Deng and his followers are still trying to put the masses in command, but in a way that will be more effective in promoting economic growth and efficiency. In agriculture, the production teams, i.e., the lowest level in the three-tier commune system, are to have their decision-making powers restored and their resources, including labor, and outputs are not to be requisitioned by others without compensation and, even then, only after consultation and negotiations with the team. In industry, the manager is to be responsible to and must consult with worker's councils that are elected by the workers.

Finally, political objectives or normative values as the basis for decision-making, behavioral rules, and policy determination are to give way to profitability, productivity, and cost reduction considerations. Investment decisions are to be based on feasibility and cost-benefit analysis. Economic levers such as taxes, interest rates, prices, etc., are to replace bureaucratic administrative decrees.

The above summary should be sufficient to indicate how the Maoist economic principles have been completely rejected in the economic reform program of Deng and his followers. These reforms represent the most complete, successful, and probably most lasting of the changes introduced by the economic reform program. It also is the portion of the economic reform program that the post-Mao leadership is most unanimously dedicated to inasmuch as it represents the operational expression of their own economic principles for achieving the economic modernization of China.

It became clear by the end of 1978, however, that the rejection of the Maoist economic principles alone was not the only modification of the traditional development model that would be required in order to achieve the modernization of China's economy. The Ten Year Plan announced by Hua Guofeng in the Spring of 1978, which was based upon the same Stalinist "big push" strategy of the past, was put on the shelf and a new "eight character" program for restoring sectoral

balance, improving efficiency, and eliminating waste was recommended at the Third Plenum and adopted at the Second Session of the Fifth National People's Congress in 1979. In essence, Stalin's "big push" development strategy was rejected and a "balanced growth" strategy was adopted in its place. It was originally believed the rebalancing of the economy could be accomplished in just 2 years; but this was later extended to 5 years. At the present time, however, it is admitted that the process of rebalancing the economy will require most of the decade of the 1980's, while it will be the last decade in this century before rapid, sustained and balanced growth can be resumed.

A major distinction between Stalin's big push development strategy, as pursued by the Chinese before the death of Mao, and the balanced growth strategy they now advocate is the rate of accumulation versus the share of national income devoted to consumption. The objective of socialist economic growth has been redefined as meeting the needs of the people and increasing their standard of living and it is recognized that the excessive rates of accumulation, i.e., over 30 percent, were a major factor responsible for the lack of significant growth in the peasants and workers standard of living between the mid 1950's and mid 1970's. The desired rate of accumulation under the new development strategy is believed to be approximately 25 percent. The post-Mao leadership also acted to immediately address the peasants and workers pent-up demand for increases in consumption by directly increasing their income. As a result of higher prices paid for agricultural products and reduced taxes levied in the rural areas; the wage increases, bonuses, and subsidies paid to workers; and price subsidies on goods purchased by the peasants and workers, this redistribution of national income in favor of consumption cost the state \$116 billion in increased budget expenditures or lost revenue in 1979 through 1981 and increased the share of consumption out of national income from 63.5 percent in 1978 to 70 percent in 1981.

This redistribution of national income from investment to consumption in the new balanced growth strategy is also complemented by a redistribution of investment to achieve a restructuring of production in favor of consumption goods.

Thus, as a share of total investment, the consumer's goods industries and agricultural sector receive a larger share than in the past, while the share going to the producers goods industries has been reduced. While a lower share of total investment goes to heavy industry, due to the much higher capital intensity of production in this sector, it still receives the largest sectoral share of total investment. Within the heavy industry sector, however, the traditional Stalinist strategy emphasis on steel and machine building production is reduced, while energy and transportation—the two most serious bottlenecks to sustained industrial growth in China today—are given much greater priority. In fact, these two sectors, along with light industry not only enjoy a much higher priority in the allocation of investment, but in the allocation of scarce inputs as well. The machine building industry is to reorganize its output mix to concentrate on the production of that machinery and equipment needed by agriculture and light industry or machinery and equipment to modernize existing enterprises. In fact, a smaller share of total investment is devoted to the creation of new production facilities (extensive development) and a greater share on the modernization of existing enterprises (intensive development) so as to better realize their production potential. The above brief description of the altered set of priorities being pursued in determining the rate and allocation of investment are sufficient to clearly indicate the replacement of the Stalinist development strategy by a balanced growth strategy in China's economic reform program.

China's economic reform program does not call for or anticipate the rejection of the Soviet model economic system; a planned socialist economy remains as a basic principle of Chinese socialism. Several prominent economists within the right-wing of the party have advocated a modification of the traditional Soviet model economic system so as to assign a greater role, although a supplemental one, to market forces and a market sector ever since the mid 1950's. Well aware of the many inefficiencies and wastes associated with the Soviet economic system, which served as an obstacle in solving the many economic problems they were trying to solve, Deng Xiaoping and his followers have supported these system reformers and incorporated a reform of the economic system itself as part of the current economic reform program. The modifications of the Soviet model economic system included in the reform program are series of experiments to decentralize decision making, to alter the method by which inputs and outputs are allocated, and to allow for some unplanned production and investment decisions within the state's planned sector. Centralized planning of output targets, the unified distri-

bution of commodities, a unified budget, and sales quotas for agricultural output have not been abandoned, nor does the economic reform program call for their elimination.

To reduce the more obvious inefficiencies and wastes associated with the traditional Soviet model economic system and to encourage local initiative in achieving greater productivity, a more balanced mix of output, higher quality of goods produced, and to better meet consumer needs the following experiments have been introduced on an experimental basis. Once the planned output target has been fulfilled, the enterprise can utilize its resources to produce additional output or different commodities for sale to state purchasing agents, directly to other state enterprises, or even to foreign buyers. These above-target sales are to be at "negotiated" prices, but these are to be subject to control by the state. To encourage this above target production and to encourage cost cutting and greater productivity, the enterprise is allowed to retain a share of the profits from these sales, including a share of any foreign exchange earned from sales abroad. These retained profits can be used for bonuses for the work force, worker's welfare fund expenditures, and—within limits—for modernizing the production facilities. To promote the initiative of local units of government in achieving greater efficiency in their operations and for sponsoring local financing of enterprises to produce commodities in short supply, their revenue sharing rates have been increased as well.

The dominant share of investment in state enterprises is financed by unilateral grants in the budget, but the experimental reforms have introduced a tax on the fixed assets of state enterprises and those enterprises can obtain bank loans to finance certain types of investment. Other experiments call for enterprise to hire its workers directly from the pool of eligible candidates, rather than have their workers assigned by the State's labor bureaus; once hired, the worker no longer is to enjoy a permanent job, but can be disciplined and, in extreme cases, fired. Finally, the state—except in cases of critical need—is no longer to guarantee the losses of an enterprise and those that cannot reduce or eliminate these losses according to a fixed schedule are to be closed down, switched to the production of a different product, or be amalgamated with other enterprises.

This brief summary of the wide variety of experiments that have been introduced over the past few years as part of the economic reform program should be sufficient to show the major features of these reforms. It is hoped that eventually the Chinese economic system will be modified so as to retain the central planning and supply system for assigning state enterprises output and delivery quotas, while relying on such economic levers as profit and capital taxes, interest rates on bank loans, prices, etc., so the individual enterprise will itself determine the most efficient means to meet its assignments in the plan. Inasmuch as it will retain its net profits, in addition to meeting its plan targets, it will also mobilize the resources available to produce additional output to meet the needs of the market.

The Chinese press in the past year has contained a small number of attacks on the existing system of collectivized agriculture, but a reform of the three tier commune system—the commune, brigade, and production team—is not part of the economic reform program. The rejection of the Maoist economic principle in this area in the past few years does not really involve a modification of the basic system of collectivized agriculture in China. That system, or the right wings version of it, was believed to be appropriate for the promotion of local initiative to achieve a higher level of productivity in agriculture that was the purpose of the systemic changes being introduced in the industrial and commercial sectors. The local cadre and peasants, however, used their initiative and greater decision making power to introduce reforms of their own; adopting contract responsibility systems similar to those that had been implemented in the 1950's and early 1960's.

In essence, the team's tax, welfare, and sales quotas responsibility is broken down and contracted out to small groups, households, or individuals who are assigned a share of the team's resources, including land, for fulfilling the contract. The income of the small group, household, or individual is then directly related to its meeting or overfulfilling their contract. A wide variety of these contract responsibility systems have been introduced. At one extreme, the team remains the basic accounting unit and all output goes to the team; a certain amount of work points awarded to those that meet their assigned quotas, bonus work points awarded those who overfulfill their assigned quotas. At the other extreme, however, the team ceases to be the basic unit of production, account-

ing, and income distribution. Rather, it becomes an administrative unit which actually allocates its resources to the households, who assume their own responsibility for taxes, sales quotas to the state, and contributions to the commune's welfare fund (for schools, hospitals, local industry, etc.). Whatever is produced above their fixed assessments, the household is allowed to keep for its own use or for sales on the market.

Faced with this growing tide of local experiments with the contract responsibility system in agriculture, the authorities have adopted this reform as part of their economic reform program. Nonetheless, those versions of the contract responsibility system in which the households replace the team as the basic unit of production, accounting, and income distribution with household farming are to be limited to those more sparsely populated and impoverished areas of rural China where the advantages of larger-scale socialized production have not yielded significant results in the past.

This concludes our brief summary of the economic reform program which has presented only the general purpose and direction of the wide variety and large number of particular economic institutional and policy changes introduced over the past three years. Yet, even this summary should be sufficient to show how this program of economic reform represents a complete rejection of the Maoist economic principles, a considerable modification of the Stalinist development strategy, and an experimental search for a significantly greater degree of decentralization and reliance on market forces within a basically Soviet model economic system. It is premature to judge how successful this search for a new Chinese development model will be in the future or to specify the development model that will finally be adopted. In the final sections of this paper, however, we can examine the economic consequences of the economic reform program thus far and, on that basis, present a few tentative suggestions about the probably characteristics of China's future development model.

III.

Most Chinese and Western observers agree that the rapid growth of China's economy in 1977 and 1978 largely represent a recovery from the poor performance in the mid-1970's and political disruptions of 1976. By 1979, however, changes brought about by the economic reform program began to have an effect and the observed major changes in economic performance in 1979-1981 can be directly related to various consequences of that program. Although the decline in the growth rate and changes in the structure of the economy are readily observable and directly related to the economic reform program, they were intended consequences of that program—a lower rate of accumulation and a reduced emphasis on heavy industry in favor of light industry and agriculture. In other words, although the annual rate of growth in national income (current prices) declined from 13.2 percent in 1978 to "more than" 3 percent in 1981, this downward trend reflected the cutback in the rate of accumulation (from 36.5 percent in 1978 to 30 percent in 1981) and in the rate of growth in the gross value of heavy industrial production (from 15.6 percent in 1978 to -4.5 percent in 1981). The growth rates achieved in light industry over this period, however, were most impressive: above 10 percent in 1978 through 1981. The record of growth for the gross value of agricultural production also is impressive in 1979, 9.2 percent; but fell to 2.7 percent in 1980, and 3.1 percent in 1981 due to bad weather. While these macro growth rates reflect the successful restructuring of the economy called for in the economic reform program they fail to reflect serious problems encountered in key bottleneck commodities—problems not solved and even aggravated by the economic reform program.

Energy is a most crucial bottleneck in China's economy at the present time, yet energy supply over the past few years has failed to increase. The economic reform program, of course, cannot be blamed for the energy problems inherited by the post-Mao leadership, but the short-run alleviation of China's energy crisis has placed considerable emphasis on energy saving in industrial production; reducing the energy required per unit of gross value of industrial output. As for the more efficient operation of enterprises as a result of the economic reforms, however, with the price of energy set by the state and at a level excessively low, Zhao Ziyang admitted in his report to the National People's Congress in December of 1981 that the "waste of energy is shocking and little has been achieved through improved management and technical transformation" at the enterprise level.

In agriculture, the most important commodity in short supply, requiring large scale imports to meet domestic consumption needs, is grain. With the pre-reform administered prices for inputs and outputs, the production of grain was one of the least profitable crops. The reforms, however, encouraged local initiative in earning more income, and emphasized negotiated output targets and sales quotas that were to be adjusted to better meet the comparative advantages of the local area, i.e., greater specialization in commercial crops. The price of grain was increased by approximately 20 percent, with a premium of 50 percent above that price for above quota sales to the state. Unfortunately, also for incentive purposes, the prices of most major agricultural crops were similarly increased, leaving the relative profitability of growing grain very low. Thus, the peasants exercised the new opportunities to increase their income to do just that, increase the production of more profitable crops. Grain output, on the other hand increased by only 4.4 percent between 1978 and 1980, while the area sown in grain declined. Furthermore, the peasants chose to consume more of the increase in grain output, feed it to their pigs, or sell it on the rural markets rather than the state purchasing agents, while state tradings agencies were not enthusiastic about buying above quota grain as they now would suffer losses in doing so.

The most major, immediate, and direct economic problems created by the economic reform programs, however, were not their failure to solve the bottleneck supply shortages inherited from the past. Rather, these were new problems and ones not associated with China's traditional development model: Budget deficits, inflation, unemployment, and an unplanned import surplus. For example, the cumulative budget deficit for 1979 and 1980 amounted to approximately 20 billion U.S. dollars, or about one-eighth of total government expenditures. On the revenue side of the budget, the tax reductions granted in the rural areas to stimulate production or sustain a minimum standard of living; the increased prices paid the peasants for their output which reduced the profits of the state supply agencies; the higher wages and bonuses paid workers, larger depreciation allowances, and larger shares of profits the enterprise could retain; and the closing of some enterprises or changing their product line were major factors in reducing revenues below the planned level. On the expenditure side, the state's attempt to cut central level investment expenditures was not entirely successful. Local units of government also used some of their funds provided by the higher revenue sharing rates to engage in unplanned investment expenditures on their own, often replicated production facilities already existing elsewhere in the economy, resulting in a competition for inputs and excess capacity.

These larger budget deficits led to inflationary pressures when they were financed, in part, by a significant increase in the money supply (bank credits and note issue) and the increased incomes of the workers and peasants and investment expenditures (both planned and unplanned) exceeded the available supply of consumer goods and construction materials and equipment. Most producers of consumer goods and supplies of bottleneck commodities in the producer's goods sector enjoyed a strong seller's market and increased prices illegally. Officially, the resulting price increases were said to be approximately 6 percent. Many visitors, however, believe the Chinese were experiencing double digit inflation due to the budget deficits and excess demand that had been created by the economic reform program.

The means used by the Chinese Communists to achieve full employment over the quarter of century after 1949—the restriction of migration and the sending of surplus labor in the urban area to the countryside to join the rural labor force—involved considerable disguised unemployment and involuntary employment. Nonetheless, everyone was assigned to some unit with work to do and received some income for that work, no matter if that income was very low. The effect of the economic reform program, however, has been to create open urban unemployment that some observers estimate to have been as large as 20 million in 1980. On the one hand, the attempt to reduce the level of investment and to switch the structure of investment from the creation of new plants to the modernization of existing ones has reduced the rate of increase in new jobs. The basic reason for the large scale unemployment in the urban areas, however, was not just the inability to find jobs for the new school leavers, but the reduced effort to force those school leavers to go to the countryside to work on state farms or in communes and allowing those sent there in the past to rejoin their families in the urban areas. It is now officially admitted that the state can no longer assure

everyone a job and those unemployed are urged to find their own private-income earning opportunities in the service sector or form cooperatives to produce goods and services for which there is a demand.

Finally, the rejection of the Maoist principle of self-sufficiency in regard to imports of foreign capital goods and technology unleashed a flood of negotiations and purchases of complete plants and capital goods imports. This growing import demand was added to when lower level units of government and even selected enterprises were allowed to negotiate directly with foreign suppliers, often with the result that duplicate sets of capital goods or those that could have been obtained elsewhere in China were purchased abroad. Furthermore, without prior estimation of sources of necessary inputs, infrastructure, or skilled labor, the assimilation of this imported technology into China's economy has encountered several serious obstacles. Despite these problems, imports increased by approximately 30 percent a year (in current values) between 1977 and 1980. Exports also increased rapidly over this period, but failed to keep pace with the growth in imports; creating a cumulative import surplus of almost 5 billion U.S. dollars in 1978 through 1980. While seeking foreign investments by means of various schemes, such as joint-ventures, special foreign investment zones, compensation trade agreements, or long-term low interest loans as a means of solving this balance of trade problem, the short-term solution was to run down foreign exchange reserves and short-term commercial borrowing and loans at high interest rates.

The emergence of budget deficits, or inflation, or unemployment, or sizable import surpluses financed by short-term capital flows in the quarter of a century before the death of Mao was sufficient to present a successful political challenge to the existing economic policies and those who advocated them. The emergence of these problems in combination and with such a direct relationship to the economic reform program being advocated by Deng Xiaoping and his followers after the death of Mao has generated similar challenges. Deng and his followers, of course, are well aware of this threat to their political support and their program of economic reform and have altered their economic reform program in an attempt to cope with and solve these economic problems. Fortunately, the causes of these economic problems and the manner in which the present leadership has reacted to them offer us some important clues as to the possible long-run future of the economic reform program itself.

IV.

The Chinese leadership, of course, did not introduce the various elements of their economic reform program and then fail to act as it created the serious economic problems described above. When they learned the Ten Year Plan announced at the First Session of the 5th National People's Congress in the spring of 1978 was infeasible, they temporarily shelved that Plan and adopted an "8 Character Program" for quickly restoring sustained growth at the Second Session of the 5th National People's Congress in the summer of 1979. The English equivalents of the 8 Chinese characters are readjusting (or the restoring balance among the various sectors of the economy), restructuring (reform of the economic system), improving (the increase in the level of technology embodied in the existing production facilities), and consolidating (the weeding out of the most inefficient and wasteful production facilities). At the Third Session of the 5th National People's Congress in the Fall of 1980, the many economic problems being created by the economic reform program were acknowledged and the Ten Year Plan was abandoned completely, while the period necessary to restore sustained growth by means of the 8 Character Program was extended to 5 years or more.

When the economic results for 1980 became known early in 1981, showing the actual course of events was even worse than expected, the plans and budgets adopted at the 3rd Session of the 5th National People's Congress were scrapped and drafts of new plans and budgets for 1981 were prepared. Since then China's economy has been operating under the guidance of one year plans which must be rather rough guidelines for actual operations and probably cover no more than the current quarter's activities. It was also decided in the Spring of 1981 that the solution to the essentially macro-economic problems of budget deficits, inflation, unemployment, and import surpluses could only be achieved through greater central control over the economy. Therefore, the experiments in reforming the economic system were to be consolidated, or put on hold, while restructuring the economy, i.e., creating greater balance in the economy, was made the highest

priority objective. Once balance had been restored, only then could the reform of the economic system be resumed.

Thus, beginning in the Spring of 1981, a dramatic recentralization of control over the economy took place: specifically, the program of central control requires all local units to strictly carry out the policies and measures of the central government; there is to be unified (i.e., central) control over all construction and investment, finance and taxes, and credit and cash management at the local level; state output and supply allocation plans must be carried out as prescribed by the state; the state's control over prices is to be strengthened and resolutely carried out; wages, bonuses, and fringe benefits stipulated by the state must be rigidly adhered to; and all foreign trade and foreign exchange is to be placed under state control. In addition, to reduce the deficit in the central government's budget and gain control over the excess funds at the disposal of local levels, treasury bonds have been allocated, i.e., sold, to state enterprises and local units of government that have accumulated their own funds. As a result of the recentralization of control in 1981, the budget deficits, inflation, unemployment, and import surpluses were brought under control and considerably reduced in 1981.

At the 4th Session of the 5th National People's Congress in December of 1981, Zhao Ziyang's Report on The Work of The Government was completely devoted to economic policy questions and reveals the pragmatic approach Deng's hand-picked successors have in attempting to restore equilibrium to the economy and regain the path of self-sustained growth. While the planner's are still working on a plan for 1982 and a Sixth Five Year Plan (1981-85) as well, the 8 Character Program is to continue with readjustment as the foremost objective, special emphasis being given the development of the energy, transportation and the consumer's goods sectors. The restoration of balance in the economy will occupy their efforts throughout the decade of the 1980's; rapid, sustained growth will not be resumed until the last decade of this century. Although readjustment remains the top priority, consolidation or the weeding out of inefficient and wasteful enterprises is assigned a greater urgency. The State Council has specified target input/output and profit or loss norms for enterprises to meet in a specific time period or be closed down. Three hundred major enterprises have been selected to begin this consolidation campaign and the campaign will be carried out by the Party Committee within the enterprise and national-level Party cadre sent down to assist them. As for improving and restructuring, technical improvements will be achieved by modernizing existing enterprises, not building new ones, and will emphasize improving the level of existing technology, not adopting the most modern technology; while the existing experiments in reforms of the economic system will be studied with the object of developing an overall plan for reforming the economic system sometime in the future.

Several policies announced by Zhao on his speech relate to the attempts to readjust or balance the economy. In the attempt to control the level of investment and reduce its inflationary impact on the economy, commodity taxes should be increased; bank deposits of local units of government, enterprises, and even individuals should be used as a source of funds for investment to a greater extent; and local units of government and enterprises should bear a greater share of the burden for providing funds for investment. Nonetheless, funds for investment will be limited and, therefore, the state cannot increase its investment in agriculture by very much. Thus, the development of agriculture must rely on adopting such policies as the contract responsibility system to create incentives for the peasants to increase output. Foreign loans will not be relied upon as a solution to the problem of insufficient funds for investment as they must be limited by China's ability to repay them and, more importantly, by the the ability to absorb and assimilate advanced technology. Nonetheless, low-interest, long-term loans will be utilized to develop the infrastructure, especially the energy and transport sector. While the growth of exports should exceed the rate of growth of the domestic economy and China's foreign trade dependency ratio should increase, imports should not include complete plants, but be restricted to imports of technology and single key pieces of equipment that are not available domestically. Finally, the increase in the standard of living must be restricted to the growth in output and, therefore, must grow slowly. Ultimately, however, the solution of this problem, as well as that of unemployment, will depend upon China's success in the birth control program.

This is where things now stand in the evolution of China's search for a new economic development model and, on the basis of this speech by Zhao, whereas

Mao is claimed to have told Hua Guofeng, "I can rest assured with you in charge," it is Deng who can more appropriately say the same to Zhao. But what do the developments in economic policy over the past year tell us about the probable character of China's new development model in the future?

To begin with the rejection of the Maoist economic principles, what was rejected was the way in which Mao's radical followers has made those principles operational, due to the negative effect they had on China's economic development. As the consequences of the manner in which Deng and his followers have made their economic principles operations, they too have generated some unacceptable effects on the economy. For example, import surpluses have led to a renewed emphasis on self-sufficiency. The rapid growth of commercial crops production at the expense of grain production has required increased imports of grain. This has resulted in renewed emphasis on self-sufficiency in grain production. The growing inequality in income distribution is leading to the imposition of constraints. Although I do not expect a return to the Maoist economic principles, I believe the trend is clear and inevitable; the right wing economic principles as they have been made operational will be modified with various controls, which will introduce considerable constraints on their implementation. With a sense of irony, one could claim this is what Mao intended all along. In any event, I believe the economic principles of China's new development model will eventually represent a compromise between the Maoist economic principles and the economic principles of Deng and his followers.

Economic reality has dictated the need to replace Stalin's "big push" development strategy by balanced growth in the economic reform program of Deng and his followers. The balanced growth strategy probably will continue until the economy is balanced and able to pursue the path of sustained and rapid growth near the end of the 1980's. Once that balance is restored, however, with the central planners in control over resource allocation and investment, the pent up demands for rapid growth, defense and key heavy industries will exert considerable pressure for a return to a big push. In fact, as long as the traditional Soviet economic system remains part of China's development model, the likelihood of a big push development strategy is very high, once balance has been restored to the economy. Many writers consider the Soviet model economic system and Stalin's development strategy as inseparable parts of what is simply called the Soviet model. One could argue that central planning and balanced growth are a contradiction. In any event, other economic systems do a much better job in achieving the objectives of a balanced growth economic strategy, while the Soviet economic system does very poorly.

It is largely in recognition of this that Deng and his followers have incorporated experiments in systemic reforms in their economic reform program. Thus, to a significant extent, the continuation of the balanced growth development strategy depends on the success of the systemic changes introduced as part of the economic reform program. Yet, when the experiments in reforming the economic system generated serious economic problems, the post-Mao leadership quickly shelved the reform program and reasserted the central controls provided by the traditional Soviet economic system. Not only did the Chinese revert to the central controls of the traditional Soviet economic system very quickly, but their doing so enabled them to quickly gain control over those problems and begin to resolve them. Wastes and inefficiencies may continue to plague the economy, but the budget deficit, inflation, unemployment, and the import surplus have been significantly reduced. This is a lesson the post-Mao leadership is unlikely to soon forget.

The Chinese leaders argue, of course, that once these problems are solved and balance is restored to the economy, they will continue to pursue the reform of the economic system. Yet, there are two critical obstacles to the implementation of a reform of the economic system that must be overcome before that reform can be successfully implemented—even after balance has been restored to the economy. Deng and his followers acknowledge that they have encountered considerable bureaucratic resistance to their attempts to reform the economic system. This bureaucratic resistance comes from the local level party cadre and bureaucratic authorities called upon to implement the reforms. The bulk of the local level cadre and bureaucratic authorities gained their experience working within China's traditional economic model. They are now being told that model was all wrong and they must adopt new principles, priorities, and methods of economic administration. Among those who offer resistance, of course, are those who are true believers in the Maoist economic principles, but a more serious

threat to the reform of the economic system are those who believe in the advantages of the Soviet economic model and Stalinist big push strategy; those who gave lip service to the reform, but refuse to act in fear of reprisals when policies again change in the future; and those who are simply incompetent and merely keep repeating what they learned in the past and are most experienced in doing. Deng and his followers recently announced a campaign to weed out those party members and bureaucrats that are resisting the economic reform program or proving to be ineffective on its implementation. It is hard to say whether getting rid of the disloyal or inefficient current low level administrators or the recruitment and training of their replacements will be the tougher job, but both will be very difficult and time consuming. Until this process of weeding out and restaffing the political and economic administrators at the local level is completed, however, the chances of significantly modifying the traditional Soviet economic system are not very great.

The second critical obstacle to a reform of the economic system is the price structure. China's post-Mao leadership recognizes the difficulty in obtaining greater efficiency and more balanced growth by means of local initiative and decision-making when the existing structure of administered prices is irrational, i.e., does not reflect the true scarcity of inputs or outputs. On the other hand, there are two major forces which prevent the Chinese from introducing a price reform. Foremost is the problem of determining how scarcity prices are to be approximated in the absence of a market economy. It is now accepted by the Chinese that the planners should rely on the "law of value" in their planning, but there is little agreement among Chinese economists on what this really means when it comes to setting a price. A more important problem, however, is that although prices have played a relatively minor role in planning and bureaucratic decisions for the allocation of resources, inputs, and outputs over the past quarter of a century, adjustments in the administrative price system were largely used to determine transfers of income among individuals, occupations, areas, levels of government, etc. In other words, the existing distribution of income in China is largely determined by the administered structure of irrational prices. Thus, any attempt to change that price system to one approximating scarcity prices will involve a very large redistribution of income. It is doubtful any leader in China could survive such a price reform in China.

These remarks about the possible fate of the economic reform program have been excessively pessimistic; an honest reflection of my own interpretation of their future. This pessimism, however, should not be interpreted to mean that China's economy will not—during the decade of the 1980's—regain the path of self-sustained and rapid growth. The new Chinese development model will, I believe, reject the Maoist economic principles as they were made operational by his radical followers before his death; will reject the Stalinist big push development strategy as excessively implemented by the Chinese before the death of Mao; and will include greater efforts to check and correct for the worst examples of inefficiency and waste caused by a dominant Soviet economic system. In short, the Chinese economic development model of the post-Mao leadership should be a considerable improvement over that before the death of Mao and should increase the probability of the ultimate modernization of China's economy.

Mr. SUTTER. Thank you very much, Bob.

We have been joined by Senator Glenn, who would like to make some remarks.

Senator GLENN. I am sorry that I was not here for the opening of the workshop, but I am pleased to be here, and will be in and out during the day. I hope we have a chance to talk to many of you about some of these problems. In the past couple of years we have investigated some of our United States-People's Republic of China relationships generally—particularly the strategic relationship with China. We have read and talked a lot more about that and the Taiwan question, and how they interrelate. Much less attention has been given to the Chinese economy and its growing importance to American businessmen so I am glad to see this conference organized by Senator Percy and Senator Hayakawa.

I think we perhaps oversold some of the short-term prospects of the China market. This has led to some disillusionment. I was one of those who went back to Ohio and was all for establishing a trading company. It was supposed to get going and get our foot in the door in China and be prepared for the long haul. I still think it is a good idea, although it is a little difficult to sustain that kind of interest with some of the difficulties that have occurred in the development of trade with China. I think it is excellent that we are assessing realistically China's short-term or mid- to long-term prospects and relate these findings to our economic plans and objectives.

I remain optimistic over the long term, although for the short term the Chinese are increasingly worried about our export controls, and despite our announced liberalization policy, we do that, on the one hand, and then seem to tighten up the restraints on Chinese textiles, for instance on the other hand.

Also, we tend in our business community to encounter very long-term delays and frustrations in trying to get into that market, but for the long term, I think much of what we are going to be able to do will depend, say, over the next 10 to 15 years, on what happens with China's development of its own resources. I think the Chinese—the drilling in the South China Sea, mineral developments out in western China, where I visited back a few years ago—will center much of it on their oil, their off-shore oil exploration which will give them the hard currency worldwide to do other things.

So, I think this is an excellent time to have the opportunity to look at some of these areas, not just in a balance of power situation, military situation, but also economic development issues. Sometimes it gets difficult in dealing with the Chinese, as you are all very much aware.

Last summer, Carl Ford and I were in China. We had meetings with top Chinese officials. We wanted to talk about some of these economic problems, and at that time the word apparently was out that they would talk about nothing but the Taiwan relationship. We were beaten about the head and shoulders at every stop up and down the road in Peking about Taiwan arms sales of any level, and the cables that we and the embassy sent back make some rather interesting reading.

They leaned on us very heavily about Taiwan arms sales. Whether it is a heartfelt feeling or whether it is sort of a flag they wave to make points, and then they will go on to other things is something I don't have an answer for.

Maybe some of you experts on China do have a better feel for it than I do, but whether we are about to have some of these other relationships held up over the Taiwan issue or not is not something that we can just ignore.

The leadership of Deng Xiaoping was mentioned, and whether or not he has his people firmly established, and where this goes, I think that is another big question mark.

I have already talked longer than I thought I was going to. Thank you very much. I am glad to be here, and welcome you, and let me just compliment Bob Sutter of CRS and Broadus Bailey and Mary Locke of our committee staff for their efforts in bringing you here today. It is an excellent group, and I hope to be in and out, and talk to you in more depth later on today. Thank you very much.

Mr. SUTTER. Thank you very much, Senator Glenn.

We will now proceed with our assessment of China's prospects and the implications for the United States, looking at the situation in China and the possible meaning this has for current and future United States-China economic relations.

Our next speaker will be Dr. Kim Woodard. Dr. Kim Woodard is the president of China Energy Ventures which he founded in January 1981, to provide professional services to companies doing energy business with China. Dr. Woodard holds a Ph. D. degree in international relations from Stanford University. He has 10 years of professional experience in the field of China's energy development and energy policies. He is the author of the *International Energy Relations of China*, which was published by the Stanford University Press in 1980. He was a post-doctoral fellow at Princeton University, and also has been associated with the East-West Center at the University of Hawaii.

Dr. Woodard, please.

**STATEMENT OF KIM WOODARD, CHINA ENERGY VENTURES,
WASHINGTON, D.C.**

Mr. WOODARD. Thank you, Bob, Senator Hayakawa, and Senator Glenn. I would also like to thank the Congressional Research Service and this committee for the opportunity to present my views on the development of the Chinese energy system and China's new program of off-shore petroleum exploration and development.

There is an inclination, both within the scholarly community and among professionals and businessmen dealing with China, to swing back and forth between very optimistic and very pessimistic evaluations of China's political and economic prospects. I recall, for example, during the 1976 to 1978 period a general feeling of euphoria over China and our relationships with that country. This euphoria extended to evaluations of United States-China trade prospects and even to specific areas such as the assessment of China's likely petroleum resources, with some observers comparing China's crude petroleum resources and oil export potential to Saudi Arabia and the Persian Gulf.

Euphoria is frequently followed by depression, and so it is in assessing China's energy prospects. We are now in a period of considerable pessimism with analysts routinely emphasizing the great constraints affecting the Chinese economy, the huge and still-growing population, technological backwardness, overcentralization and bureaucracy, capital constraints, transportation constraints and the like. Far from projecting a picture of China as the next Saudi Arabia, a recent study, and a very thorough study at that, by the World Bank projects that China's demand for petroleum and other energy commodities may soon outstrip production, replacing the country's present limited but commercially significant coal and oil export capacity with a staggering oil import requirement by the end of this decade. We can come back to the export-import balance for energy commodities in the discussion.

I would prefer in my comments today, as also in my written report, to underscore the balance in the Chinese energy system, and indeed throughout the Chinese economy, between potential and constraints. There is little question that China's energy resource potential ranks

among the richest energy resource bases in the world. Recoverable coal resources alone are ranked at some 600 billion tons, or enough to continue current levels of production for at least 1,000 years.

With its many river systems and mountainous terrain, China is also blessed with vast hydropower potential, theoretically enough to run an electric power system the size of that of the United States on hydropower alone. On-land crude petroleum and natural gas resources are more limited, but still significant. Current crude petroleum reserves are roughly 10 billion barrels, while economically recoverable oil resources from on-land basins—I want to underscore on-land basins alone—are frequently estimated at about 40 billion barrels, or four times current reserves.

The Chinese Ministry of Petroleum reports, however, that only 20 percent of the country's sedimentary basins have been explored, and that preliminary seismic surveys of the Sichuan, Qaidam, and Tarim Basins and central and western China indicate a vast unproven petroleum resource potential.

The Chinese Continental Shelf, which is now in the earliest stages of development, is comparable in surface area to Texas and Oklahoma combined, and is underlain over nearly this entire area with sedimentary basins of thicknesses ranging up to 5,000 meters. It is still too early to assess the petroleum resources of the shelf with any degree of confidence, but seismic surveys in the Yellow Sea and South China Sea indicate as many as 400 possible petroleum-bearing trap structures.

Four of nine wildcat wells drilled by French and Japanese operators in the Bohai Gulf and the Gulf of Tonkin during 1981 are ranked as discoveries with commercial potential. Some analysts compare the likely petroleum potential of the South China Sea portion of the shelf alone to the Gulf of Campeche, and the potential resources of the entire shelf to the North Sea.

An enthusiastic report of an early broad gage seismic survey of the East China Sea concluded that "a high probability exists that the continental shelf between Taiwan and Japan may be one of the most prolific oil reservoirs in the world." The area referred to is the subject of a jurisdictional dispute among China, Japan, South Korea, and Taiwan, and is unlikely to be developed until the dispute can be resolved.

A second potentially very rich area lies directly south of the mouth of the Pearl River and Hong Kong, and this area is now just opening up for bids. Other areas of possible commercial interest are the Yinggehai Basin south of Hainan Island and the Beibu Wan Basin in the Gulf of Tonkin.

The coming year is likely to be an exciting one in terms of the rapidly expanding role of the American petroleum industry in China's offshore oil exploration effort. Invitations to bid on 4 blocks in the northern Yellow Sea and 22 blocks in the central portion of the South China Sea were issued to 46 foreign oil companies just a week ago, on February 16. Offshore petroleum regulations, detailed tax codes, and the announcement of a new China National Offshore Oil Corporation were then issued in the space of a few days, establishing a legal, tax, and organizational framework for the offshore projects.

Intention to bid must be indicated by participating companies by March 30, and bids sent in by June 30 of this year. The Chinese side is then expected to take about 3 months to evaluate the bids and to invite certain companies to Beijing for another 3 to 4 months of contract negotiations. Final contracts should be in hand by January to March of 1983, with drilling beginning in the summer of 1983.

Two American companies, Atlantic Richfield and Santa Fe, already hold a large joint contract area south of Hainan Island and are planning to begin drilling later this year.

Exploratory drilling should accelerate rapidly during the 1983 to 1986 period, with deployment of 20 to 30 rigs on at least 10 contract areas in the South China Sea alone by 1985 or 1986. China meanwhile is establishing three or four principal supply bases at 400-kilometer intervals along the South China Sea coastline. No commercial oil production is likely before the closing years of the decade from the continental shelf, except for the less than 10,000 barrels per day, and that is a rather small amount, currently produced from three fields in the Bohai Gulf by the Chinese.

Despite an early lead by a Japanese consortium and two French companies, which began drilling in the Bohai Gulf and the Gulf of Tonkin in early 1981, the American petroleum industry is likely to take a predominant role in exploration of the shelf, particularly in the South China Sea. Beijing is very cautious not to signal a preference for American oil companies in the bidding process. Nonetheless, 24 of the 46 companies eligible to bid, and the 2 additional companies that already have a contract area, are based in the United States.

Furthermore, if one were to take into account relative technological and financial resources of the various companies, the U.S.-based participants hold at least 90 percent of the offshore exploration assets in question. Beijing is well aware of this fact of life, and the Chinese legal and tax codes governing the offshore project are carefully tailored to permit smooth entry of U.S.-based companies.

Aside from the American exploration companies, the entire support infrastructure of the American petroleum industry is slowly gearing up for operations offshore China. Even allowing for use of the Chinese rig fleet, for example, the People's Republic of China is unlikely to be able to meet the drilling requirements of such a large exploration program, especially in the near term, and there is room for at least 10 to 15 foreign rigs operating in the new contract areas, particularly in deep-water drilling.

The new offshore regulations give preference to Chinese supply and equipment companies where competitive, and one should underline the term, where competitive, but it would require years if not decades for the People's Republic of China to provide entire panoply of technical services, chemicals, and advanced drilling equipment required to sustain the offshore drilling fleet.

There is considerable room, therefore, especially in the short term, for foreign services and suppliers. If successful, United States-China cooperation for offshore development would be the largest single commercial enterprise ever undertaken between China and any foreign country or group of countries, overshadowing other large projects in

the steel, petrochemical, and fertilizer industries. Exploration investments alone—and this is at the early exploration phase—are projected at \$1 to \$3 billion between 1983 and 1985, with another \$1 billion required to develop the supply base infrastructure.

If exploratory drilling yields commercial discoveries, development of those discoveries into producing fields would cost about \$10 billion for each additional million barrels per day of output capacity, and that is in 1980 dollars. Investment in the South China Sea alone should reach \$10 billion in 1980 dollars, or about double that figure perhaps in 1990 dollars, depending on the state of the economy, and ultimately two or three times this figure. So you are talking about long-range investments in the range of, say, \$50 billion.

Investments on this scale entail a level of risk not previously encountered in commercial relations between the United States and China. Some of these risks are political in nature: The stability of the present Chinese Government over a 20- to 30-year time horizon, remaining jurisdictional disputes along the Chinese continental shelf, or the possibility of hostilities between China and Vietnam or Taiwan. These risks and the severe constraints that affect all economic programs in China should be kept firmly in mind when evaluating the potential of the offshore projects.

Nonetheless, it can safely be said that offshore oil exploration is the most promising single area of potential cooperation between China and the United States during the 1980's. Thank you.

[Mr. Woodard's prepared statement follows:]

PREPARED STATEMENT OF KIM WOODARD

There is, today, no more exciting an economic or political development in the People's Republic of China than the imminent prospect of petroleum exploration on the Chinese continental shelf. With the announcement just days ago of invitations to 46 foreign oil companies to bid on hundreds of thousands of square kilometers of the shelf for contract exploration rights, Beijing is opening an entirely new petroleum exploration theater that is roughly as large in area as Texas and Oklahoma combined. The resultant bidding, contract negotiations, and early exploratory drilling are likely to generate a wave of new optimism over China's economic prospects and commercial relations between the United States and China.

Against this background of natural enthusiasm, both within China and in the international news media, it is doubly incumbent upon us to provide a sober and measured evaluation of progress in China's energy industries. We must above all emphasize the enormous constraints that continue to limit the pace of energy and economic development in China as well as recognizing the growing pressure on Chinese energy and economic resources generated by the development needs of a still-growing population of 1 billion people. China is already the third largest energy producer and consumer in the world in aggregate terms. But in terms of average per capita standards of living, China remains a developing country, with 80 percent of the people living on the edge of poverty in rural areas. China's energy and economic potential is great, even if measured by world standards. But much remains to be done if that potential is to be realized over the coming decades.

It is also the case, given the centrally planned structure of the Chinese economy and its avowedly Marxist political leadership, that there is no distinct boundary between our commercial and political relations with China. Given our experience with Soviet industrialization and its political and military sequelae, we must continue to ask ourselves just how far the United States Government should go in encouraging the transfer of advanced energy and industrial technologies to the People's Republic of China. Our commercial opening to China should be as

carefully thought out and implemented as cooperation in political and security matters. The Chinese political system appears to be evolving, however haltingly, in the direction of greater freedom for the Chinese people, greater openness and restraint in the practice of government, and perhaps even toward greater popular participation in government. We must constantly monitor and encourage these developments, and measure our contribution to the more immediate objectives of Chinese modernization in accordance with deeper political trends.

CHINA'S ENERGY RESOURCES

China's commercial energy resource base is demonstrably one of the largest in the world. Coal resources are comparable to those of the United States and the Soviet Union, and are usually ranked third in the world. Measured and inferred coal reserves have recently been placed by official estimates at 600 billion metric tons, or enough to provide for production at current levels for roughly 1,000 years. In-place coal resources are perhaps 2-3 times this figure, at 1.5-2.0 trillion metric tons. Most of the coal resource is in the form of high-quality bituminous, with limited amounts of anthracite and coking coal.

Crude petroleum and natural gas resources are not as plentiful as coal resources, on either an absolute or relative scale. China's current crude petroleum reserves (proven plus probable) are in the neighborhood of 10 billion barrels, or 15 years of production at current levels. However, Chinese geologists have explored only about 20 percent of the total area of sedimentary basins that might have conditions favorable for oil and gas recovery. Economically recoverable resources from onland basins might reasonably be projected at about 40 billion barrels, or four times current reserves. About 90-95 percent of China's current crude oil reserves are located in the "northeast corridor" fields—Daqing, Shengli, Dagang, and Renqiu. Of these, Daqing holds roughly half the current reserve. Promising additional onland exploration areas are in sedimentary basins in Sichuan Province, the Caidam Basin (Qinghai Province), and the Tarim Basin (Xinjiang Province). We return to a discussion of offshore resources below.

Little is known outside of China regarding the extent of natural gas resources. Natural gas is found in associated form in all of the oilfields of the northeast corridor. In addition, there are "dry" (non-associated) gas fields southwest of Shanghai and in extensive deposits in Sichuan Province. The Caidam Basin holds considerable proven gas reserves, but these are "locked in" by the lack of a pipeline to industrial areas in the central and northeast parts of the country. A reasonable estimate of recoverable natural gas resources might be in the vicinity of 1 trillion cubic meters (35 trillion cubic feet), not a large figure by international standards.

Hydropower resources, on the other hand, fed by China's vast river systems, are among the very largest in the world. Chinese hydrologists put total exploitable hydropower resources at 380 gigawatts potential, or roughly enough to run the entire U.S. electric power system on hydropower alone. Of this potential, roughly 15-20 gigawatts are being utilized or are under development. Under Maoist economic policy, some 90,000 small-scale hydropower dams were installed in the rural areas to provide electricity to village-level enterprises. This program is being continued, but has been deemphasized in favor of large-scale hydropower projects by the current administration.

Beyond these conventional, commercial energy resources, China's rural population depends on a variety of traditional, non-commercial energy fuels for household use. Chinese experts have placed rural consumption of such traditional fuels as firewood, crop residues, and dried animal dung at as much as 300 million tons coal equivalent per year, or about one-third of China's total annual energy consumption. Consumption of traditional fuels tends to be relatively constant over time, with population growth balanced by substitution by coal and other commercial fuels. Heavy use of firewood, including sticks, leaves, and other forest debris, is causing serious deforestation problems and erosion in certain parts of the country.

China also has the potential, in the longer term, for development of geothermal power and nuclear power. Geothermal resources are located across broad reaches of the country in thousands of steam and hot water surface vents. Located at the intersection of three crustal plates, the country is criss-crossed by active earthquake zones and has numerous shallow magma pockets. Only half a dozen

geothermal deposits have been tapped so far for district heating and small power generators.

The nuclear industry in China was developed starting in the late 1950s and has been devoted so far entirely to military and research purposes. At the present time, the country possesses one mid-sized gaseous diffusion plant and at least two plutonium reactors that are utilized to create fission fuel for nuclear weapons. There are several active uranium plants, producing perhaps 1,000-2,000 metric tons of yellow cake each year from three active mines. Uranium discoveries of unstated size are mentioned in the Chinese press from time to time, indicating resources with potential commercial application, should Beijing decide to proceed with plans to import foreign reactor technology. Discussions have been held with Framatome and some American nuclear reactor manufacturers, but to date the high capital cost of commercial nuclear reactors has repeatedly delayed the conclusion of final contracts. If nuclear reactors were to be introduced into the Chinese power grid, the most likely locations would be power-short coastal cities such as Guangzhou (Canton), Shanghai, or the industrial cities of the northeast.

CURRENT STATE OF THE ENERGY INDUSTRIES

Despite the enormous potential of China's energy resource base, and the additional potential for offshore oil development (see below), China's current energy situation is not favorable for rapid growth in the economy during the 1980's. With the exception of the electric power industry, which continues to expand at a modest pace, China's commercial energy industries, including coal, oil, and gas, have been at an output plateau since 1978. Coal production grew at an average annual rate of 7.0 percent from 1970 until 1978, and then leveled off at just over 600 million tons per year, where it has since remained. Crude petroleum output, which had expanded at a spectacular 15 percent per year in the 1970-1978 period, stopped growing at just over 100 million tons per year (2 million barrels per day), or only one-fourth peak U.S. output. Natural gas production followed a similar pattern of rapid growth in the early 1970's, followed by subsequent stagnation in the industry. Furthermore, there appears to be little relief in sight in the years ahead, as Chinese planners have projected small annual increases in coal production and no further increase in crude oil output through the middle of the decade.

Table 1: China's Primary Energy Production and Oil Exports, 1970-81

Year	Raw coal (mmt)	Crude oil (mmt)	Natural gas (bcm)	Hydropower (tkwh)	Total energy (mmtce) ^a	Petroleum exports ^a		
						Crude (mmt)	Products (mmt)	Total (mmt)
1970	354.0	30.7	2.9	20.5	305.0	-0.4 ^c	Negl.	-0.4 ^c
Annual growth rate, 1970-75	6.2%	19.4%	22.4%	16.8%	9.1%	n.a.	n.a.	n.a.
1975	482.2	77.1	8.9	47.6	481.8	9.9	2.2	12.1
Growth rate, 1975-76	0.3%	11.9%	13.6%	-4.3%	3.4%	-15.2%	-4.7%	-13.2%
1976	483.5	86.8	10.2	45.6	498.3	8.5	2.1	10.6
Growth rate, 1976-77	13.0%	7.5%	17.1%	4.5%	11.4%	6.8%	4.7%	6.4%
1977	550.7	93.6	12.1	47.7	558.3	9.1	2.2	11.3
Growth rate, 1977-78	11.5%	10.5%	12.4%	-6.7%	10.7%	21.7%	8.7%	19.3%
1978	617.9	104.0	13.7	44.6	621.5	11.3	2.4	13.7
Growth rate, 1978-79	2.8%	2.0%	5.7%	11.6%	3.0%	17.8%	34.8%	21.0%
1979	635.5	106.1	14.5	50.1	640.2	13.5	3.4	16.9
Growth rate, 1979-80	-2.5%	-0.2%	-1.4%	15.0%	-1.3%	-0.7%	16.3%	3.5%
1980	620.1	106.9	14.3	58.2	632.1	13.4 ^d	4.0 ^d	17.5 ^d
Growth rate, 1980-81 ^c	0.0%	-4.5%	-9.5%	3.0%	-1.3%	-11.0%	0.0%	-9.0%
1981 ^c	620	101.2	13.0	60.0	624.1	12.0	4.0	16.0

^a Gross exports

^b Million metric tons coal equivalent

^c Author's estimate

^d Planned

SOURCES: Official data from the Ministries of Coal, Petroleum and Electric Power

Data supplied by the author. Reprinted courtesy of "Problems of Communism."

**Table 2: Chinese Crude Oil Production,
by Field, 1977-80^a**

(million metric tons)				
	1977	1978	1979	1980
Northeast corridor	88.1	96.2	97.0	95.6
of which:				
Daqing fields	50.3	50.4	50.8	51.5
Shengli fields	17.5	19.5	18.9	17.6
Renqiu fields	12.3	17.2	17.3	16.0
Liaohu fields	4.5	5.7	6.6	7.1
Dagang fields	3.2	3.0	2.9	2.9
Other	0.3	0.4	0.5	0.5
Northwest region	4.2	4.9	5.7	6.1
Central-South region	1.3	2.8	3.4	4.2
Southwest region	0.1	0.1	0.1	0.1
TOTAL	93.6^b	104.0	106.1^b	105.9^b

^a Total 1981 output is projected by the author at about 100 million metric tons or 2 million barrels a day, based on half-year output figures.

^b Differs from total of regional figures due to rounding of the latter.

SOURCES: Ministry of Petroleum.

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The impact of the output plateau in the energy industries has been felt throughout Chinese industry, and indeed in the economy as a whole. The problems affecting the energy industries are deeply imbedded in the structure of the economy and include the following:

1. Regional imbalance

Early exploration and development of China's coal and petroleum resources were heavily concentrated in the northeast corridor. Today about 95 percent of crude petroleum output comes from the area from just south of Beijing to the northern border of Heilongjiang Province, with half of the country's oil industry dependent on a single producing area—Daqing oilfield. This regional imbalance has resulted in a pattern of rapid early growth and later stagnation, as if the northeast corridor were a country unto itself, with a regionally imposed resource constraint on production. Other regions (e.g. the Shanxi coal belt) hold rich hydrocarbon resources and should be developed to balance early dependence on the northeast corridor.

2. Poor resource management

The Maoist approach to economic development, which stressed a "guerrilla campaign" style in the development of basic industries, laid heavy emphasis on current output at the expense of capacity expansion and rational resource management. Coal mines were stretched to the absolute production limit with little care taken to add new shafts as old mines were depleted. Producing wells at Daqing oilfield and in other fields were pushed to the limit with water injection systems, causing early waterflooding and greatly raising the cost of oil extraction at later stages in development.

3. Backward technology

During the 1950's, before the Sino-Soviet split, the Chinese oil and coal industries were built up on a foundation of obsolete Soviet technology that had been

acquired in turn by the Soviets from the West. Much of this technology is still in evidence in Chinese mines and oilfields, being too expensive to replace with modern imported equipment. Furthermore, Chinese machine-building industries are also geared to produce yet more equipment of antiquated design. The importation of modern petroleum and coal equipment from Japan, the United States, and Western Europe has created an overlay of better technology in a few locations, but has done little to relieve the underlying problem. The systematic destruction of indigenous technical expertise by repeated antiintellectual programs, culminating in the Cultural Revolution, blocked what might have been an indigenous community of scientists and engineers. The consequent delay in development of an indigenous energy technology should be measured in decades. Steps are now being taken, particularly through educational exchanges with the United States, to alleviate this condition, but they will require another decade to take hold.

4. Capital constraints

Despite a great deal of media attention to decentralized energy programs, such as the small-scale hydropower stations or small coal mines, at least 75 percent of the production capacity of China's commercial energy industries has always been under the direct control of central government ministries. Today, the Ministry of Coal controls large mines with two-thirds of China's total coal capacity, while the Ministry of Petroleum controls 100 percent of crude petroleum production capacity. A very high proportion of capital investment in the coal and oil industries is therefore channeled through these central ministries. This strategy worked as long as new capital equipment acquisitions were primarily from the indigenous machine-building industry at state-controlled prices. But just as soon as Beijing attempted to import modern coal and petroleum equipment from Japan and the West, serious government deficits and foreign trade imbalances followed. Efforts to restrain deficit capital spending and to restore the balance of trade led in 1980 to a severe retrenchment in capital expenditures and to a sudden drop in foreign energy equipment imports. Beijing is attempting to decentralize its energy industries through the introduction of a corporate structure and by allowing individual enterprises to retain a margin of profit and to make semi-autonomous investment decisions. But the basic structure of the central planning apparatus remains intact, and severe capital constraints should continue to be felt throughout the 1980's.

5. Inefficiency of energy utilization

For 30 years Beijing structured its energy plans around centrally-imposed output targets. Indeed, the emphasis on volume of output in the primary energy industries continues today, with annual production figures routinely compared to state targets. This planning practice has led to over-allocation of available energy commodities to industry, under-allocation to agriculture, transportation, and the commercial sector, and to one of the worst energy end-use efficiency records in the world. By its own admission, China consumes roughly twice as much commercial energy per unit of GNP as neighboring Asian countries. Or put the other way around, China gets about half as much economic growth per Btu of commercial energy consumption as Thailand or Indonesia. Since 1980, Beijing has begun to introduce a serious energy conservation program, particularly in industry. But continuing distortions in the price structure for energy commodities, with some (e.g., gasoline) priced above normal market rates and others (coal, kerosine) well below market rates, will make the "conservation pad" difficult to narrow.

In the long run, none of these basic structural constraints in the Chinese energy system need prove insuperable. To the great credit of Deng Xiaoping and his modernization program, all of these problems have been opened up for discussion, both within the planning apparatus and in the public media. Steps are being taken to restructure the entire economy in a way that will rationalize planning and management, eliminate egregious waste, conserve energy and other resources, and permit the gradual decentralization of basic investment and pricing decisions. These measures will take time. China's energy industries will remain at their current output plateau until well into the 1980's, with gradual improvement thereafter. Given the rising pressure of domestic energy consumption requirements generated by an expanding industrial base and a growing population, the margin of energy commodities available for export to the international market will be quite narrow.

ENERGY COMMODITY AND EQUIPMENT TRADE

The PRC has long been involved in trade in energy commodities on the international market, both as an importer and exporter. During the 1950's, China imported about half of its annual consumption of refined petroleum products—gasoline, kerosine, and diesel fuel—primarily from the Soviet Union. These product imports peaked in 1960 and declined rapidly after the rupture in political relations between China and the Soviet Union. The loss of Soviet refined products caused a serious domestic energy crisis between 1961 and 1964 and had a devastating impact on the transportation and industrial sectors. China managed to obtain some refined products from Rumania and other countries during the 1960's, but strove to replace imported petroleum with the development of Daqing oilfield and indigenous refineries. This effort was successful, as China achieved complete energy independence in the late 1960's.

Coal production, on the other hand, has always been sufficient for domestic consumption requirements, with a narrow margin available for export. During the 1950's and 1960's, China exported coal to the Soviet Union, Japan, Hong Kong, Pakistan, and other countries. These early coal exports peaked at 1.7 million metric tons in 1967, and then declined to about half a million tons per year during the 1970's.

By the time of the celebrated "opening to the West" in 1971, crude petroleum production from Daqing, Shengli, and Dagang oilfields in the northeast corridor was increasing at some 20 percent per year and began to outrun additions to domestic refinery capacity. This led to an offer in April 1973 to export a limited quantity of Daqing crude oil to Japan. The offer was accepted and China became a regional petroleum exporter, eventually selling crude and petroleum products to Japan, Vietnam, North Korea, Hong Kong, Thailand, the Philippines, and a few countries outside of the region. At its peak in 1979-1980, petroleum export reached 17 million tons per year (340,000 barrels per day) of which 13.5 million tons per year (270,000 b/d) was crude petroleum and the rest petroleum products, including jet fuel, gasoline, diesel, kerosine, and lubricants.

In early 1980, faced with a persistent plateau in crude petroleum production and pressure from rising domestic oil demand, Beijing decided to limit oil exports to a fixed ceiling. Exports to Japan were limited to 8.3 million tons per year (165,000 b/d) and contracts with other countries were either limited to a fixed volume or eliminated. This brought a decline in total petroleum exports during 1981 to about 16 million tons (320,000 b/d). If onland petroleum production can be held to 100 million tons per year (2 million b/d) over the coming years, Beijing plans to continue petroleum exports at roughly current levels between now and 1985. Petroleum exports will not begin to increase again until offshore oil production is initiated in the late 1980's. Indeed, the World Bank has forecast a short-term drop in petroleum exports under the pressure of rising domestic demand, although Chinese planners publicly dismiss this forecast as too pessimistic. It is clear, however, that China will remain a predominantly regional, small-scale petroleum exporter for the remainder of this decade.

A very limited quantity of Chinese crude petroleum and gasoline have reached west coast markets in the United States. There is no immediate prospect of large-scale Chinese petroleum exports to the United States.

China's coal exports began to increase in 1978 under the terms of the long-term trade agreement signed with Japan in that year, totaling 5-6 million tons by 1981. Coal exports to Japan are scheduled to rise to 3.5 million tons this year, about half of which is steam coal and the rest coking coal. Aside from Japan, China exports coal to North Korea, Hong Kong, Pakistan, and several European countries. Transportation constraints, particularly insufficient harbor loading facilities, may slow the expansion of coal exports in the near term. But coal exports are expected to reach 10 million tons per year by 1985 and perhaps twice that figure by 1995. Efforts are being made to develop large mines in the Shanxi coal belt (north central China) under the terms of compensation trade contracts with Japanese and American coal companies. If successful, these contracts will further increase the volume of coal exports. There are virtually no resource constraints on China's coal export capacity.

There has long been a direct connection between China's energy commodity exports and the import of foreign energy technology, plants, and equipment. Between 1973 and 1978, energy commodity export earnings totaled about \$4 billion,

almost exactly the import bill for the energy plants and equipment imported during the same period. By 1980, the year of peak coal and oil export earnings, China earned some \$4.7 billion from international energy markets. During 1979 and 1980, despite the ceiling on crude oil exports imposed by the output plateau in the domestic oil industry, earnings continued to climb under the impact of the sharp price rise (\$14 to \$35 per barrel) of crude on the international market. But by 1981, under the pressure of a falling international market, China's oil export earnings declined to about \$4.1 billion.

The United States has been an indirect beneficiary of China's coal and oil exports. Between 1973 and 1978, U.S.-based energy equipment manufacturers captured about 10 percent of the total Chinese market for foreign energy plants and equipment. By 1979 and 1980, however, our position in the Chinese equipment market had improved sharply, in line with the general improvement in our trade relations with China. Total United States-China trade doubled to more than \$4 billion in 1980, and then grew by an additional 40 percent in 1981, reaching nearly \$6 billion. (Final trade figures for 1981 are not yet available.)

Close examination of United States-China trade data, however, reveal that exports of American petroleum equipment to the PRC are highly sensitive to China's position in international energy commodity markets. U.S. exports of petroleum exploration equipment to China jumped from \$46.3 million in 1978 to \$222.4 million in 1979 as China's oil export revenues ballooned. By 1980, however, with Chinese trade officials anticipating the plateau in oil export revenues, new orders for American exploration equipment dropped to \$87.7 million. Petroleum exploration equipment exports to China were off even further last year, totaling about \$60 million for 1981. If it can be anticipated that the current plateau in China's crude petroleum output and exports will continue through the mid-1980's, then there is little prospect that petroleum equipment sales to China's domestic on-land oil industry will increase substantially above current levels. This situation has proven a grave disappointment to U.S. petroleum equipment manufacturers, who had hoped to penetrate the Chinese market still further during the 1980's. There remains, however, the prospect of an expanding petroleum equipment market in China's offshore development program, to which we turn next.

OFFSHORE PETROLEUM EXPLORATION

Offshore exploration along sections of China's 6,800 kilometer coastline began in the late 1960's and have been underway ever since. The first broad-gauge seismic survey of the Chinese continental shelf was conducted by a U.S. Navy survey ship under contract with the Committee for Coordination of Joint Prospecting for Mineral Resources in Asian Offshore Areas (CCOP), an offshoot of the United Nations Economic Commission for the Far East (ECAFE). The CCOP surveys of the Yellow Sea, East China Sea, and South China Sea portions of the shelf were conducted during 1968 and 1969, while the Chinese government was preoccupied with the war in Vietnam and the Cultural Revolution.

Despite the limitations on the CCOP surveys, which were conducted using widely-spaced seismic lines, aeromagnetic profiles, aerial gravimetry, and dredged samples, they revealed the existence of vast sedimentary basins along virtually the entire area of the shelf, with sediment thicknesses in some basins reaching as much as 5,000 meters. An enthusiastic report of the early surveys concluded that "A high probability exists that the continental shelf between Taiwan and Japan may be one of the most prolific oil reservoirs in the world." The central area of the South China Sea shelf, directly adjacent to Hong Kong and the mouth of the Pearl River, is another area judged to have great hydrocarbon potential.

Table 3: O'/shore Exploration Activity, 1968-81

Date	Location	Activity	Operator	Result
1968-70	East China Sea Yellow Sea South China Sea	Seismic surveys	United Nations ECAFE	Identified major sedimentary basins
1974	Bo Hai	Seismic survey	Compagnie Française Géophysique	Not known
1972-75	Yellow Sea	7 exploratory wells	South Korea ^a	No commercial discoveries
1974-77	East China Sea	24 exploratory wells	Taiwan ^a	3 oil and gas shows
1974-78	Bo Hai	Seismic surveys	PRC Geological Bureau	Basic mapping
1969-80	South China Sea Bo Hai	Approximately 100 exploratory wells	PRC Ministry of Petroleum	22 oil and gas shows. Production about 0.5 million metric tons/year, or 10,000 barrels/day
1980	Bo Hai	Seismic surveys	46 foreign companies	Profiles on 215,000 sq. kilometers
1976-80	South China Sea	18 exploratory wells	PRC Ministry of Geology	9 oil and gas shows
February-March 1981	Gulf of Tonkin	Wushu 16-1-1 well	Total China	4,700 b/d API 44° crude, ^b plus 129,000 cu. meters/day natural gas
Dec. 1980-May 1981	Bo Hai	BZ 28-1-1	Japan National Oil (JNOC)	7,300 b/d API 39° crude, ^b plus 600,000 cu. meters/day natural gas
February-July 1981	Bo Hai	PL 71-1-1	Elf Aquitaine	Minor oil and gas shows
May-? 1981	Gulf of Tonkin	Weizhou 11-1-1 well	Total China	Not yet known
May-Sept. 1981	Bo Hai	Well on Chengbei structure	JNOC	2,600 b/d crude, plus 27,000 cubic meters/day natural gas
Aug.-? 1981	Bo Hai	Wildcat well	JNOC	Not yet available
August 1981	East China Sea	Longjing-1 well	PRC Ministry of Geology	Oil and gas shows

^a Various companies operating in government concessions.^b Degree API is "specific gravity measured in degrees on the American Petroleum Institute scale. . . On the API scale, oil with the least specific gravity has the higher API gravity. Most crude oils range from 27 to 35 degrees API gravity." See Howard R. Williams and Charles J. Meyers, *Oil and Gas Terms*, 3rd ed., New York, NY: Matthew Bender, 1971, p. 19. Thus, the crude from this well is at the light (and hence valuable) end of the API range.SOURCES: Kim Woodard, *The International Energy Relations of China*, Stanford, CA: Stanford University Press, 1980, Chaps. 7 and 8; and various issues of *Petroleum News* (Hong Kong).

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The revelations of the CCOP surveys led to a scramble among littoral states during the early 1970's to assert jurisdictional control of the shelf. Japan, South Korea, Taiwan, and China made conflicting claims to Yellow Sea and East China Sea sectors. The Philippines, both Vietnams, Cambodia, Indonesia, Taiwan, and China laid claim to vast reaches of the South China Sea and its scattered islets. Drilling programs were hastily organized by each of the claimants, in order to reinforce their claims by planting the flag with the drill-bit. Not counting China, the rival claimants and foreign companies working in hastily-drawn concession areas drilled some 110 wells in the Yellow, East China, and South China Seas between 1972 and 1977. The results of these early drilling programs were very poor, with only 22 hydrocarbon shows. Only one area, the Nido complex offshore Palawan, was subsequently developed on a commercial scale. By 1978 these early programs had slowed or halted, with concessionaries relinquishing their contract areas to government-sponsored exploration programs. Active drilling does continue in one area, the Japan-(South) Korea Joint Development Zone in the East China Sea.

Meanwhile, China had initiated its own domestically-controlled offshore exploration program, beginning in 1966. The first offshore wells drilled by the Chinese were along extensions of the "graben" (geological formations) that form the Dagang oilfield. The first wells were drilled along the marshy borders of the Bohai Gulf from causeways. Crude drilling barges and drilling platforms on wooden piles followed. Then, during the mid-1970's, using advanced seismic vessels imported from France, China began to conduct broad-gauge surveys of the shelf, including the Bohai Gulf, the Yellow Sea, and parts of the South China Sea portions of the shelf. Beijing also imported a fleet of 8 modern jack-up drilling rigs from yards in Singapore and Japan and bought a used Norwegian (Aker H-3) semisubmersible rig of advanced design. These imported rigs were added to a small fleet of drilling barges and jack-ups of Chinese design built in domestic shipyards. The entire fleet was operated by the Ministry of Petroleum and Ministry of Geology between 1976 and the end of 1980.

The early Chinese drilling program was a notable effort for a country with no offshore petroleum experience, but it yielded only mixed results. Drilling activity was the greatest in the Bohai Gulf, where Chinese rigs completed nearly 100 exploratory (wildcat and delineation) wells and discovered two major fields and three smaller fields. Production platforms have been constructed on three of the Bohai fields, with initial production reaching less than 10,000 b/d (500,000

metric tons per year), or 0.5 percent of China's total crude petroleum output. This is, perhaps, not much to show for ten years of effort and about a billion dollars in investments. An active drilling program was also conducted in the South China Sea between 1978 and 1980, with 19 exploratory wells yielding five "discoveries" in the Beibu Gulf (Gulf of Tonkin) and two more discoveries in the area south of the Pearl River. A few scattered wells have also been drilled by Chinese rigs in the Yellow and East China Seas, most recently at a point just 50 kilometers west of the boundary of the Japan-Korea Joint Development Zone, a zone which the PRC has never accepted.

In parallel with the development of an indigenous offshore exploration program, Beijing began to feel its way toward involvement of foreign oil companies. By 1977, several Chinese delegations were dispatched to visit offshore drilling activities in the Gulf of Mexico, and in early 1978, discussions began with a number of U.S.-based oil companies regarding technical exchange programs that had a distinct offshore dimension. By November 1978, when Secretary of Energy Schlesinger visited the PRC and signed a basic framework of agreements for United States-China cooperation in energy fields, foreign involvement in oil exploration on China's continental shelf was being actively discussed.



By mid-1979, these discussions reached fruition in a complex series of agreements between 48 foreign oil companies and the Petroleum Corporation of the PRC (and indirectly the Ministry of Petroleum) under which the foreign companies pooled their resources to conduct more intensive seismic surveys in two zones in the Yellow Sea and six additional zones in the South China Sea. The seismic survey cost was born in entirety by the companies (totaling about \$200 million), with the understanding that at a subsequent stage, participants in the seismic work would "hold the key" for bidding privileges on any areas of the shelf that the Chinese decided to develop in cooperation with foreign exploration companies. The seismic surveys were basically completed during 1980, and each participating company submitted complete set of data and interpretations to the Petroleum Corporation of the PRC by June 1981.

Meanwhile, to the enormous frustration of the American companies that had agreed to the seismic surveys, Beijing signed exploration contracts with the Japan National Oil Corporation, with Total Chine (a subsidiary of the French government-controlled company CFP), and with Elf-Aquitaine for exploratory drilling on four large contract areas in the Bohai Gulf and the northeastern portion of the Beibu (Tonkin) Gulf. These early contracts were of a joint-equity joint-venture type that the American companies subsequently rejected in favor of a more standard Indonesian-style Production Sharing Contract (PSC) format. The bidding date for American company contract areas was pushed back from early 1981 to mid- and then late-1981, and finally to February 16, 1982 when bidding procedures were finally announced and relevant exploration and tax regulations published.

Early drilling on the Japanese and French contract areas, which began at the end of 1980, has had some promising results. To date, the Japan National Oil Company has drilled five wildcat wells in the Bohai Gulf, to which two were listed as discoveries with commercial potential. The Japanese hit a substantial oil reservoir on the first well down, which tested at 7,300 barrels per day of light, high quality crude. This is one of the largest discoveries in the history of the Chinese petroleum industry and caused quite a stir in the international media. Subsequent discoveries have not been so dramatic. Elf-Aquitaine drilled two wells to about 4,000 meters in the central area of the Bohai Gulf that had sub-commercial hydrocarbon shows and were abandoned. Total Chine struck oil on the first well down in the Beibu (Tonkin) Gulf, a potentially commercial discovery that tested at 4,700 b/d from two producing zones. A second Total Chine well has just been completed and the test results have not been announced, but are rumored to indicate another discovery. Thus in sum, of 9 wildcat wells drilled by French and Japanese operators, 3-4 have been listed as discoveries with commercial potential, an impressive result.

THE AMERICAN ROLE IN CHINA'S OFFSHORE DEVELOPMENT

Despite the early emphasis on China's indigenous offshore program and the early contracts with French and Japanese companies, there is little doubt that U.S.-based exploration companies will be China's predominant partners in developing the hydrocarbon resources of the continental shelf. Of the 46 foreign oil companies that hold the "key to the door" (participation in the seismic surveys) for the round of bidding that is about to begin, 26 are based in the United States.

If an accounting were made of the relative financial and technical resources of the eligible companies, 90 percent or more of those resources would be found in the hands of U.S.-based companies. Beijing is well aware of this reality, and in fact has geared the legal, tax, and contract framework for the bidding and subsequent exploration to the needs of U.S.-based companies, at times incorporating their suggestions directly into the texts of relevant statutes and tax codes.

If all goes according to plan, bidding, bid evaluation, contract negotiations, and final awards will require about a year to complete from the date when the call for bids was initiated (February 16, 1982). The bidding schedule on 4 blocks in the Yellow Sea and 22 blocks in the South China Sea will run approximately as follows: Purchase of bidding packets (including intent to bid) by March 30, 1982; bid submission by June 30, 1982; bid evaluation by October-November 1982; and contract negotiation and awards by January-March 1983.

Two American companies (Atlantic-Richfield and Santa Fe) reached an early non-competitive agreement for a large contract area south of Hainan Island, an agreement that was announced June 4, 1981. Assuming that the final touches are put on the operational agreement for this contract area soon, ARCO/Santa Fe may begin drilling later this year.

In concert with the call for bids, Beijing also announced the promulgation of a basic legal framework for offshore development (the Offshore Petroleum Regulations); a detailed tax code that will be applied to offshore exploration and development ventures (Foreign Enterprise Tax Regulations); and the formation of a new petroleum corporation that will function as a single point of authority for the offshore projects (China National Offshore Oil Corporation, or CNOOC). These steps have been monitored very closely by the affected companies. The general impression is that Beijing is displaying considerable flexibility in establishing a viable framework for commercial offshore exploration.

The Offshore Petroleum Regulations provide the first Chinese statutes directed specifically to the needs of foreign participation in offshore exploratory drilling and subsequent development and production of petroleum resources along the Chinese continental shelf. Important sections of the Regulations include the following:

- Chinese ownership of all imported equipment, excepting leased equipment, until legally exported beyond Chinese territory;

- The right of exploration companies and foreign subcontractors to repatriate profits and export authorized shares of crude petroleum production;

- Preference for Chinese services, equipment, and personnel in subcontracts and supply contracts for offshore exploration and development, where competitive;

- Chinese ownership of all imported equipment, excepting leased equipment, which may be removed after the projects are complete;

- Duty-free status for imported petroleum equipment to be used in the offshore projects;

- Provisions for the legal registration of companies and subsidiaries, as well as arrangements for banking, insurance, and tax assessment;

- Training of Chinese personnel and planned technology transfer, according to a reasonable schedule of increased local participation;

- Various legal protections for foreign subcontractors.

These provisions are not unusually harsh by international standards, and in fact may be found in the laws of petroleum producing countries around the world. They notably do not include a legal requirement that all companies participate in joint ventures, but rather allow for the registration of wholly-owned foreign subsidiaries operating on Chinese soil and in Chinese waters. The Chinese may still press for joint venture arrangements in negotiations with individual companies, but there is room under the law for a variety of arrangements. A strict joint venture requirement would have excluded many American companies from participation.

The basic provisions of the Foreign Enterprise Tax Regulations have also been carefully designed to meet the needs of American companies. Specifically, the tax code has been applied across-the-board to all mineral and non-mineral foreign enterprises, thereby averting the treatment of Chinese petroleum profits taxes as a royalty by the U.S. Internal Revenue Service. Chinese corporate income taxes have a top bracket in the range of 50 percent of profits. If this tax were non-creditable against U.S. corporate income taxes, all of the American exploration companies would quickly withdraw. Beijing has avoided this by tailoring the basic provisions of its tax codes to U.S. creditability requirements. The detailed tax regulations were just announced today (February 22) and have not yet been provided in translated form. But it is likely that they will prove creditable once the IRS has examined them in detail over the coming weeks.

The China National Offshore Oil Corporation has just been established formally, with Qin Wencai, a figure well known to the American petroleum industry, as its first President. The principal Vice-Presidents and the mandate of the CNOOC have also been announced, but detailed information is lacking about its internal structure or external relationships to other parts of the Chinese bureaucracy. CNOOC has overall responsibility for the exploration, development, and production phases of the offshore projects. It is not yet clear whether the new corporation will be a subsidiary of the Petroleum Corporation of the PRC, or directly responsible to the Ministry of Petroleum. CNOOC will have under its jurisdiction a number of new and preexisting offshore corporations, including the South Sea Branch (formerly part of the Petroleum Corporation of the PRC); the China Ocean Engineering and Service Corporation (rig towing, service boats, diving, platform construction, etc.); the China Offshore Petroleum Design and Engineering Corporation (engineering and design of

production systems); parts of the China Shipbuilding Corporation (rig construction and repair); and the Offshore Aviation Service Corporation (helicopter services). This list is far from complete, lacking for example a specialized drilling contractor or a labor contractor, but the network of offshore subsidiaries to CNOOC will expand with time and experience.

On balance, American petroleum companies welcome the formation of a single Chinese offshore oil corporation that will replace the current welter of conflicting authorities. We are hoping that the new corporation will be staffed with technically competent personnel, and that it will have authority to act commensurate with its responsibilities. It is still quite likely that foreign exploration companies will have to deal with a multiplicity of authorities, including Guangdong Provincial authorities, the Ministry of Geology, customs and trade agencies, and communication and transportation agencies, to name just a few. It would be helpful if CNOOC would establish an authoritative theater command headquarters somewhere on the South China coast, rather than remaining behind thick grey walls in Beijing.

The scale of likely American involvement in oil exploration offshore China is revealed by basic estimates of the projected capital cost of the projects to U.S.-based petroleum companies and eventually to the American banking and financial community. The 26 U.S.-based exploration companies made a small downpayment of \$2-3 million each to participate in the seismic surveys and analysis of the seismic data upon which the entire bidding process rests. They will pay another small but tidy sum to acquire the bidding packets, the sale of which has just been announced. If bidding and contract negotiations go forward on schedule, each successful company will pay contract bonuses and other entry fees and deposits early next year.

These introductory costs, however, are minor compared to costs that will be incurred in the exploration stage. For each successful offshore contractor, a specified number of wells must be drilled within the first 3 years of the project, as well as two subsequent 2-year intervals. Areas not drilled are subject to relinquishment at successive intervals. Each exploratory well drilled on the Chinese continental shelf will cost \$8-10 million (1980 dollars). A modern mobile offshore drilling rig leases (with crew) for \$45,000 to \$90,000 per day. With twenty rigs projected to be in operation on at least 10 contract areas by 1985, exploration costs will total \$1-3 billion between 1983 and 1985. The numbers will go much higher by the late 1980's. The construction of 3-4 offshore supply bases along the Chinese coastline (in the South China Sea alone) will cost an additional \$1 billion. These figures are not enormous by the standards of U.S. Government budgets or the American petroleum industry, but they are very large indeed in the framework of United States-China commerce.

If the early exploratory drilling is successful, establishing commercial discoveries on a scale sufficient to warrant development, then the scale of investment will shift upward yet another order of magnitude. The infrastructure of production platforms, subsea pipelines, refineries, and export terminals required after commercial discoveries are made costs roughly \$10 billion for each million barrels per day of production capacity. Traditionally, the oil companies themselves provide the risk capital during exploratory drilling. Once commercial discoveries are confirmed, banks and other financial institutions provide capital for the development and production stages. The Bank of China will have a very large role in arranging and perhaps funding these very large capital requirements. But it will probably do so in concert with a number of foreign banks, including notably the larger Hong Kong banks and several of the largest U.S. banks. (Citibank, First Chicago, Chase Manhattan, Bank of America, and other banks have already expressed interest.) William Lear, Vice President of the First National Bank of Chicago, has estimated that total capital requirements for the South China Sea alone will be \$10 billion (1980 dollars, or \$20 billion in current dollars) by 1990. Depending on the rate of discoveries, the ultimate capital requirement could be twice or three times this figure.

Because of the preference clause in the Offshore Petroleum Regulations, much of this investment will be captured by the Chinese economy, and will benefit the Chinese petroleum industry and coastal development in Guangdong Province in particular. But much of the investment will be returned to the United States in the form of additional business for our own petroleum industry. Especially in the near term, China will simply not be able to provide sufficient technical expertise, trained personnel, or advanced drilling equipment to satisfy the needs

of rapidly expanding exploration programs. Beijing has accepted this fact of life by providing room under the preference clause for non-Chinese subcontractors in such areas as drilling operations, data analysis, equipment manufacture and supply, communications and transportation, specialized testing services, and so on. Without these essential supports, the offshore projects either could not function at all, or would be interminably delayed. In the longer term, we can expect that China's own petroleum industry will assume an increasing share of these support responsibilities.

On balance, then, there is reason to be satisfied and optimistic regarding the role of the American petroleum industry in China's offshore development. Indeed, measured on any scale whatsoever, United States-China cooperation in offshore exploration and development will be the largest single commercial enterprise ever undertaken between China and any foreign country or group of countries, overshadowing previous efforts to enlist foreign technology in the Chinese steel, petrochemical, and fertilizer industries. Propelled by the offshore projects, United States-China trade, which has been expanding at a healthy rate for the past several years, will take further giant steps forward, perhaps eventually rivaling trade between China and Japan. If the offshore projects are successful in producing sufficient oil for additional Chinese petroleum exports to the international market, then the volume of trade will expand still further, by relieving the capital and foreign exchange constraints that currently limit Chinese development budgets.

IMPLICATIONS FOR UNITED STATES-CHINA RELATIONS

Let us return for just a few moments to the underlying political issues raised at the beginning of this paper. As stated at the outset, it is vital that we measure the benefits of economic cooperation with the People's Republic of China, not only in commercial terms, but also in terms of our basic objectives in East and Southeast Asia.

The political relationship between the United States and China is based, as indeed since its inception, on the belief that the gradual assimilation of the People's Republic into an evolving framework of regional stability is far preferable to China's previous isolation. I think that the events of the past decade bear out this assumption, despite the obvious facts that the Chinese government is by no means a democracy, individual freedoms hardly register on the scale of political values in China, and that China by no stretch of the imagination could be described as a market economy, even if current reforms take root.

The integration of China in an orderly fashion into the Asia-Pacific region involves not only the establishment of a stable web of political and security relationships between Beijing and the other capitals of the region. It also implies an ever-expanding network of commercial ties with China, both for the United States and for our regional partners, especially Japan and the ASEAN countries. Cooperation in various energy fields and especially in the development of oil resources along China's vast continental shelf can contribute greatly to this commercial interchange, as outlined above.

We should, however, be aware that we incur certain political risks by opting into China's oil and energy development programs. Perhaps the greatest of these risks is that the programs themselves may fail, or may succeed only marginally. The political legitimacy of Deng Xiaoping and the "modernizers" who currently control the Chinese Communist Party and the government of China, rests directly on the success of their efforts to reform the economy and to produce a "modern socialist industrial society" by the turn of the century. This is an ambitious undertaking. Each new oil discovery on the continental shelf is heralded in the Chinese press as a harbinger of the coming of modernity and vindication of Deng's programs. If the oil simply isn't there, or if acrimony or impatience spoil the atmosphere of cooperation between the American and Chinese petroleum industries, the blame is likely to be shifted in the direction of the entire framework of United States-China relations. Conversely, if the modernizers fall before the scythe of a new radicalism in the Chinese Army or the Party, the offshore projects and the enormous investments they represent would be jeopardized. This risk is far from trivial, given China's political history to date and the 20-30 years required for the offshore projects to come to fruition. A Chinese refusal to honor \$10-20 billion in investment obligations would have a devastating impact on political relations.

The offshore projects also pose some risks for our relations with China's neighbors. Our regional allies have little objection to the development of United States-

China commercial ties, except in the direct sale of military equipment to China. But the PRC does have outstanding jurisdictional disputes with a number of countries over its claims to broad areas of the East China Sea, Yellow Sea, or South China Sea. These disputes are currently quiescent, with ritual restatements of claims but no effort to enforce exaggerated interpretations of sovereign rights to otherwise insignificant islets. Indeed, Japan and China have held low-level discussions of possible joint development of disputed areas of the East China Sea. But a sudden flare-up of tensions with Taiwan or Vietnam could easily produce a new hardening of positions in the offshore jurisdictional disputes. There is some risk of open conflict between China and Vietnam over disputed jurisdiction of the central portion of the Beibu (Tonkin) Gulf. Such a conflict, or an offshore extension of renewed Sino-Vietnamese border war could be particularly dangerous, since the Soviet Union is now assisting Vietnam with its own offshore development program and is using former U.S. naval facilities at Da Nang and Cam Ranh Bay.

None of these political risks, in my judgment, would warrant abandonment of the offshore projects, or even their curtailment. The United States Government, however, along with the American petroleum industry and the American financial community, would be well advised to monitor the political dimensions of any project of this scale undertaken in cooperation with China. The offshore projects in particular should be closely monitored, and significant risks identified as far in advance as possible.

Beyond the limited political risks involved, we should look forward with great enthusiasm to a new stage in the development of commercial relations between China and the United States. If the offshore exploration projects are successful, they hold the promise of cementing a decade of steady progress in the political and economic relations between the world's most populous country, and the world's most powerful industrial democracy. The American petroleum industry in particular should be given credit for its patience and foresight in opening up this new area of cooperation between the two countries.

Mr. SUTTER. Thank you very much, Dr. Woodard.

Our next speaker will be Prof. Nicholas Lardy. Professor Lardy is an associate professor of economics at Yale University and assistant director of the Economic Growth Center at Yale University. He has published widely in many well-known periodicals, such as the *China Quarterly*, and he has received a variety of awards and fellowships, including the Henry R. Luce Foundation Award, the American Council of Learned Societies. He has received postdoctoral research grants awarded by the Social Science Research Council and the American Council of Learned Societies.

Professor Lardy, please.

STATEMENT OF PROF. NICHOLAS R. LARDY, YALE UNIVERSITY, NEW HAVEN, CONN.

Mr. LARDY. Thank you very much, Bob.

In the brief time allocated to me I would like to provide an interim assessment of China's readjustment process that has been underway for the past 3 to 4 years. I would like to contrast the differential performance in the two major sectors of the Chinese economy, the agricultural sector and the industrial sector of the economy.

In my judgment, there has been very substantial success in the agricultural sector over the past few years. This can be measured in terms of output growth. If you look at the rate of growth of major agricultural products between 1977 and 1980, they are at historically very high rates. Grain output has grown at 2.7 percent per year, cotton output 7 percent per year, oil-bearing seeds 17.7 percent per year, sugar beet and sugarcane 10.4 percent per year, meat products about 11.5 percent

per year, with additional growth in almost all of these categories in 1981, so there is a very substantial rate of growth over the past 3 to 4 years.

Equally important, I would judge, is the decline in costs. In other words, these increased levels of output have been achieved with a slight decline in costs of production as productivity of resource use in the agricultural sector has increased. I think most of this productivity increase can be attributed to the kinds of reforms that have been undertaken within that sector.

I am thinking in particular of greater trade, specialization in agricultural production, some reemergence of comparative advantage cropping regionally within China, and equally important, a decentralization of production decisions to small groups and households, in other words, the restoration of production incentives and a curtailment of the classic free rider problem that existed throughout the sixties and most of the seventies, when there was pressure within the system to move toward what the Chinese refer to as higher levels of socialization, that is, having larger and larger units serve as producing and accounting units.

I think both from the perspective of the growth of output and improved productivity in the agricultural sector, that agricultural development in the past few years has met with considerable success. I think it is fair to say that food consumption levels are for the first time well above the levels of the 1950's or even of the 1930's, so that the agricultural sector has had a considerable resurgence in the past few years.

In terms of the trade implications of that resurgence, it is probably fair to say that China will continue to be a major importer of cereal crops from the United States and other Western countries, but that their imports of refined sugar, edible vegetable oils, and cotton will continue to decline as they have for the past few years. Thus one can probably look forward to somewhat less rapid growth of total U.S. agricultural product export to China and perhaps even stagnation of exports in that particular category over the next few years as China moves away from almost an exclusive emphasis of grain production and returns to comparative advantage cropping of the type that Bob Dernberger mentioned in his remarks earlier this morning.

Now, in contrast with that, the industrial sector has been much less dynamic. I would say that my conclusion here is very much in line with Bob Dernberger's, that the reforms have had only marginal effect in improving productivity. I think that improving productivity essentially has to be taken as the underlying central objective of the reform and readjustment period.

In other words, the move toward a somewhat more market-oriented form of resource allocation in the industrial sector has been, as Bob Dernberger has pointed out, basically curtailed within the last 2 years. It seems to me there are really three problems. The first of these is the price structure under which they are operating. A move toward a more autonomous enterprise decisionmaking system implicitly must be based on a profit-oriented system of incentives, yet there is little prospect that this will improve the performance of China's industrial system since the price structure is by and large unrelated to domestic production costs or to product scarcity. It has been designed tradi-

tionally for income distribution purposes, as Bob Dernberger mentioned, and also, obviously, revenue generation purposes, which he was also implicitly including within his definition.

So, consequently, encouraging enterprise managers to maximize their profits rather than to follow a centrally directed economic plan will probably reduce social welfare in China. Indeed, that is one of the problems they have encountered as they have attempted in a limited way to put that kind of reform into effect. So, an overhaul of the price structure is an essential precondition for the success of profit-oriented industrial reform. There is no indication that the Chinese with the possible exception of a few individuals have even begun to think very seriously about that.

The second problem with the reform of the industrial sector is that it encountered very high transition costs in a move toward a more decentralized system.

Mr. SUTTER. Excuse me, Nick. This room doesn't have very good acoustics, so would you please speak a little louder, because the people behind you probably are having a tough time hearing.

Mr. LARDY. There are relatively high transition costs encountered. In other words, as the Chinese moved toward a more market-oriented system, they encountered higher unemployment rates as excess labor began to be laid off, and of course, there were revealed substantial excess capacity in certain branches of industry as the market evidenced little demand for output of certain sectors of the economy. I think there were not a few people in the leadership who were enamored of the idea of getting a great productivity payoff from reform, but they became disenchanted when they saw what the high transition costs of the supposedly more productive system were.

The third problem, and one that is more fundamental, is the loss of control that the decentralized system ultimately implied. Reform was desirable in theory, but it essentially implied a loss of control of resource allocation power that people at the center proved unwilling to accept. So for the past 2 years we have had a recentralization of economic decisionmaking, particularly in the industrial sector, although much less so in the agricultural sector: a retreat away from the drive toward a market socialism that was evidenced a few years ago; and a return to a high level bureaucratic decisionmaking, subject, as it always has been in the past, to disruption and to internal disagreement. I think that is the situation that we see today, where the Chinese are unable even to put forward at the major Congress in December an economic plan for 1982.

Not only have they been unable to publish or even draft the outline of the current 5-year plan, which began more than 2 years ago, but they were unable to even come up with an annual plan. They have been unable to come up publicly, at least, with a budget for 1982, which is unprecedented in the past few years. In previous years, the budgets for the following year have always been announced, in broad outline, if not in great detail. This year, they were unable to do that. We have no outline of the 5-year plan. We have no 1982 economic plan, and we have no budget for 1982. When I say we don't have them, I don't mean that I can't read them, but all the evidence is that they don't exist anywhere in China as well.

Chinese economic growth probably will pick up slightly in the next 2 years from the very low rates of growth particularly in the industrial sector, achieved in the last 2 years. But recent growth has been fueled by more buoyant agricultural growth, but my expectation is that this growth is likely to slow down as the Chinese move toward increasingly restricting the dynamic agricultural sector. That is, considerable evidence suggests that they have been moving to curtail the markets and specialization that have been the central source for productivity growth in the agricultural sector.

They are putting more of a squeeze on the marketing activities that have been allowed to reemerge since 1978, more emphasis on bureaucratic resource allocation in agriculture. My fundamental feeling is that if they continue to put additional restrictions on the agricultural sector as they have in the past on the industrial sector, that the rate of growth of the economy will probably begin to decline even below the relatively low rates of the past few years.

[Mr. Lardy's prepared statement follows:]

PREPARED STATEMENT OF NICHOLAS R. LARDY

INTRODUCTION

Economic policy in China over the past several years has focused on achieving several major structural changes. Among the most important of these has been to reduce the rate of investment and increase the share of output devoted to current consumption; to shift the composition of output somewhat away from its traditional emphasis on heavy industry and toward light industry and to a lesser extent agriculture; and to alleviate several critical bottlenecks, notably in the energy and transportation sectors. These and closely related changes are designated as "readjustment" in discussions in China. At the same time a significant minority within China simultaneously have promoted a series of potentially far-reaching changes in China's basic economic system. These changes, which are designated as "reform," have as a central objective improving the efficiency of resource use.

While the twin objectives of reform and readjustment may be complimentary in the long run, the simultaneous pursuit of both objectives has proven unusually difficult in the Chinese economic environment. The resulting shifts in emphasis after the death of Mao Tse-tung, initially reform but beginning in 1979 shifting toward readjustment, have been widely noted in the West and frequently interpreted as reflecting the ascendancy and subsequent decline of a "reformist coalition." While that formulation may contain an element of truth, it obscures the large overlap of objectives that are shared by both those favoring readjustment and those promoting reform, and fails to clarify important issues relating to the appropriate sequence of the two objectives. Moreover, it implicitly assumes that the reform coalition has a fixed blueprint for reform when what we have seen is a series of genuinely groping experiments that have highly uncertain outcomes. Since Professor Robert Dernberger's paper lucidly explicates the details of the reform and readjustment programs, I would like to devote my limited space to examining economic performance since 1977, where possible relating this to the reform and readjustment program, and to explaining why reform has now been deferred in favor of readjustment.

AGRICULTURAL GROWTH AND PRODUCTIVITY

Reforms in the agricultural sector have been more far-reaching and more successful in raising productivity than have reforms in industry. Major policy changes in agriculture included substantial increases in 1978, 1979, and 1980 in the prices the state pays farmers for agricultural products. These were the first significant price adjustments in more than a decade and cumulatively prices rose more than a third. Equally important state imposed constraints on the operation of traditional periodic rural markets have been eased. Significant quantities of many agricultural commodities since 1978 have been traded in private markets for

the first time since the first half of the 1960s, when the state also followed a more relaxed policy on rural private marketing. The state has allowed and to some extent facilitated the reemergence of specialized cropping of noncereal crops based on comparative advantage rather than attempting to impose self-reliance in cereals on all regions and localities. Finally the state has allowed the decentralization of production decisions to small groups or even households under what is known as the "responsibility system." While these arrangements preserve public ownership of land and usually of tractors and other productive assets, devolving production responsibilities to very small groups has had a dramatic effect on incentives. Because of the difficulty of measuring the actual contributions of agricultural workers to collective activities, large production and accounting units inevitably had encouraged slackening of work efforts since for any individual the reduction in reward from collective activities was far less than the individual's reduction in labor input. Contracting production to small groups or individuals effectively controls that classic free-rider problem.

Between 1977 and 1981 agricultural performance was, by any recent historic standard, unusually high. Between 1977 and 1980 grain output grew 2.7 percent annually; cotton, 7 percent; oil bearing seeds, 17.7 percent; sugar beet and sugarcane, 10.4 percent; meat products, 11.5 percent (all average annual rates). Almost every category experienced significant additional growth in 1981. More significant than the growth of aggregate output has been the decline in costs. After more than a decade in which production costs increased more rapidly than output, production costs as a share of output after 1977 began to decline gradually. In short, agricultural growth in the past three to four years has been characterized by significantly improved productivity in the use of resources. For reasons discussed further below, I believe that much of this increased efficiency in the use of resources can be attributed to reforms that have been carried out in agriculture.

Increased aggregate output is, of course, partly due to increased supplies of modern inputs such as chemical fertilizer and of certain types of machinery. But increased productivity is largely the result of reforms. Most important among these are the relaxation of the policy of local foodgrain self-sufficiency and less pressure for uneconomic forms of multiple cropping of grains. Those cropping patterns had frequently been imposed bureaucratically from above with the objective of increasing grain output with little regard for the substantially increased costs that were incurred. Moreover policy has supported a reemergence of cropping patterns based on the principle of comparative advantage. That policy, reflected in increased specialized cropping of nongrain crops, notably cotton, sugarcane, peanuts, etc., has been facilitated to some degree by state supplies of cereal crops in areas that have shifted production to nongrain crops.

The reemergence of specialized cropping of noncereal crops has two major implications. First, it has contributed significantly to increased productivity growth since comparative advantage cropping a priori implies more efficient use of resources. Second, it has important implications for China's pattern of trade. In the decade between 1966 and 1976 as a grain sown area expanded at the expense of noncereal crops, China's imports of many agricultural products, notably cotton, edible vegetable oils, and sugar, grew extremely rapidly. In the past two years imports of these crops have begun to decline as a more rational pattern of cropping has reemerged in China. Since with the exception of sugar, the United States has been the major supplier of these crops, United States sales to China in these categories are likely to continue to decline over the next year or two. While grain sales will probably continue to be stronger, it is not inconceivable that total U.S. agricultural sales will continue the decline that began in 1981. Because agricultural products have comprised over half of total U.S. exports to China in recent years, unless there is offsetting growth of U.S. exports of machinery, equipment, and other industrial products, total U.S. exports to China may stagnate or even decline in the next year or two.

INDUSTRIAL PERFORMANCE

Judging the influence of economic reforms on industrial sector productivity is quite complex. Industrial growth has been relatively slow, but that reflects a deliberate policy choice, part of the readjustment program of reducing the output of the heavy industrial sector while accelerating the growth of the somewhat smaller consumer goods sector. Policy has been successful in that regard. Output of consumer goods has grown at record rates for the past four years, while output of producer goods has grown modestly or in some years, actually declined.

While the changing mix of industrial sector output has been congruent with policy objectives, I believe that there is little evidence to support the view that reforms of industrial planning and management have increased the productivity of resource use. The reasons for this somewhat disappointing productivity performance are complex and not well understood. While subsequent evidence may point to alternative interpretations, in my judgment two central causes deserve careful consideration.

The first of these is the existing industrial price structure. A movement away from the objective of plan fulfillment toward a more decentralized system in which enterprise managers have considerable autonomy in decision making implicitly must be based on a profit-oriented incentive system. Yet rewarding enterprise managers for high profitability rather than fulfillment of detailed plans specified in quantity terms is not likely to improve the performance of Chinese industry. Such a shift is likely to have a positive efficiency only if the existing price structure reflects domestic production costs and product scarcity. Yet China's price structure reflects neither relative scarcities or production costs. It is, with few exceptions, designed to generate government revenues, not to influence the allocation of resources. The Communist leadership in the early 1950's essentially abandoned their only attempt to generate significant revenues through direct taxes and shifted to indirect taxes that are embodied in the price structure. With only modest exceptions, the price structure established in the 1950's has endured to the present. While it may be a useful structure for redistributing resources away from agriculture and toward industry, away from consumption and toward investment, etc., it was not designed to allocate resources and will not now serve that function without considerable revisions.

One of the most important reasons that reform in industry was curtailed was that profit maximizing by enterprise managers led the economy rapidly in directions that did not improve either planners' or social welfare. The consequence was that more direct forms of bureaucratic control of resource allocation and current production were rapidly substituted for the more decentralized experiments that had been started.

A second cause for the differential performance on productivity in agriculture and industry is that while the agricultural reforms were implemented across the board, those in industry were carried out on an experimental basis—concentrating on industry in designated provinces and in designated product lines. Yet, as Thomas Rawski has pointed out in an important unpublished paper ("The Chinese Economy: Post-Mao"), a priori one would expect that major gains from reform would not be apparent until most, if not all, of the enterprises are subject to the new system of incentives. Enterprise managers in the reformed sector may wish, for example, to reduce the excessive inventories they have built up as a cushion against the supply uncertainty that characterizes a system in which all important inputs are allocated bureaucratically. These large inventories, while dysfunctional from the point of view of the whole system, may be perfectly rational from the point of view of enterprise managers in a system where penalties for failing to meet output targets are high and costs of working capital are very low. Under the reformed system, with higher costs of working capital and inter-enterprise relationships determined by mutual contract with penalties for late delivery by suppliers, enterprise managers may reduce their inventories, thereby contributing to a more efficient industrial sector. But in China only some of the enterprises operated under the new rules. While a manager of an enterprise subject to the new system of incentives might wish to reduce inventories, if inputs were supplied by enterprises still under the old regime, his incentives to do so would be significantly curtailed. In short, the ability and willingness of enterprise managers to respond positively to reform depends on external conditions, and the benefits of reform can be expected to multiply as the share of firms operating under the reformed system grows. The somewhat limited sphere of industrial reform may have curtailed the reform's potential for increasing productivity.

PROSPECTS

Judging the future path of Chinese economic policy, particularly economic reform, is clearly a hazardous task. The short-run outlook, however, is for more emphasis on centralization of decision making under the guise of readjustment. That judgment is based on two factors. First, as already noted, the price structure is not propitious for a shift to more decentralized forms of decision making. The price reforms that are an essential precondition for the success of any

market-oriented reform appear several years off, at best. Second, there are significant vested bureaucratic interests that remain opposed to the long-run implications of a more decentralized system. These groups appear to value reform only in the short run. The substantial agricultural growth stimulated by the reforms in agriculture are now thought to provide the basis for a return to the traditional big-push strategy with its emphasis on high rates of investment and heavy industrial development financed by a squeeze on the agricultural sector of the economy. Evidence of this is already beginning to emerge. The state has imposed increasing restrictions on the operation of rural private markets since peasants have chosen to market their increased output privately rather than selling it to the government. Promised reductions in the prices of agricultural producer goods such as tractors, fuels, and electricity, have not been fulfilled. Similarly the share of state investment allocated to agriculture has not increased at the schedule proposed at the Third Plenum of the Eleventh Central Committee and ratified at the Fourth Plenum in September 1979.

Mr. SUTTER. Thank you very much. I think we are beginning to get a solid picture of some of the economic tensions that prevail in China today.

We would now like to turn to some of the political tensions as they affect economic development in China and United States-China economic relations. We will do that with Lyman Miller from the Central Intelligence Agency. Dr. Miller has been a Chinese affairs analyst at the CIA for 8 years. He has studied Chinese history at Princeton and George Washington Universities, and has studied in Taiwan and Japan. He spent last summer in the People's Republic of China. He is the author of several articles on Chinese foreign policy and domestic politics. I would emphasize that Dr. Miller is speaking solely in his own capacity, and does not represent the views of the CIA or any other U.S. Government institution.

Dr. Miller, please.

STATEMENT OF H. LYMAN MILLER, CENTRAL INTELLIGENCE AGENCY

Mr. MILLER. Thanks for reiterating that disclaimer. I would have done so myself.

I would like to make a few points about the political context in which the economic reforms have been implemented in the past few years. The present climate in China favoring increased economic interaction with foreign countries is to a great degree part and parcel of the broad series of reforms across the board which the Chinese leadership has implemented in the years since Mao Tse-dong's death in 1976. In the minds of most observers, these reforms were first identified with the Chinese Communist Party's [CCP] veteran leader, Deng Xiaoping. To a large extent, the future of this climate favoring increased foreign economic intercourse is tied up with the future of those reforms about whose prospects I would like to suggest just a few points.

First of all, in my view, Deng's reforms were mutually reinforcing. That is, his economic reforms, for example, are backed up by a variety of other social, educational, institutional, and political reforms which taken together comprise a package of related policies and related attitudes toward China's modernization. The impact of this mutual coherence of policies politically is that success on one policy front has a reinforcing effect on the success or outcome of other reform policies on other fronts. By the same token, failure on one or more of these reform

fronts can quickly and easily translate into setbacks on the other policy fronts. That is to say, damage to part of Deng's reform program, can hurt the whole of his reform package all together.

Second, I think the party faces rising expectations among the Chinese populace for a larger direct share of the fruits of China's economic modernization. These expectations put a certain amount of pressure on reformers to succeed in their policies. In part, the reformers themselves are responsible for raising these popular expectations of prosperity by projecting optimistically, for example, that average worker incomes would reach certain high levels within so many years. To some extent already the party in China has acknowledged failure in meeting some of these expectations.

One glaring example was the New Year's Day editorial in 1981 in the party's paper, *People's Daily*, in which an editorial acknowledged that:

In the past, due to our lack of understanding of and consideration for the national conditions and our failure to explain them properly, we made casual remarks and promises and drafted some impractical plans for future economic development, even though we were motivated by the fervent hope to make the country strong and the people happy. We caused complaints and disappointments among the people because these promises and plans did not materialize.

In my view, the particular plans and promises to which they were referring were, in fact, the economic reforms that were put into practice in the previous year and a half up to that point.

The third factor I would like to suggest or lay out is that the party itself faces what it itself calls a crisis of confidence, that is, a spreading belief even among its own membership that the CCP cannot effectively guide China's modernization. This sort of disaffection complicates implementation of the reform policies among an already demoralized party rank and file, and it is the primary focus of recent propaganda campaigns in China stressing that "only socialism can save China," which was, for example, the major theme of the party's 60th anniversary celebrations last year.

A fourth factor that I would like to suggest is that the political context in which the reforms are being implemented remains difficult. The main reason for this is that the various reform policies which Deng has put forward have a sensitive political history. Many specific policies, for example, the agricultural reforms, were vilified during the Cultural Revolution as amounting to the restoration of capitalism in the countryside and as violating the revolutionary principles upon which the regime was founded.

Consequently, cadres of local levels wait and see. They hesitate to implement policies which they fear are rightist or for which they might be taken to task should a more rigorously orthodox leadership emerge in Peking.

This larger political situation affecting implementation of the reforms at lower levels accordingly puts a very high premium on consistency of support for the reforms by the Peking leadership. The leadership, in fact, has not provided such continual reassurances of constancy. For example, regarding the central Government's overall line on economic development, we have seen a shift in the leadership's line in 1978 from a Stalinist program of high targets and emphasis on heavy industry to centralized sectoral readjustment in 1979, to decen-

tralizing structural readjustment and reform in 1980, and back again to recentralizing readjustment in 1981.

The current program is a modification somewhere in between some of these lines, which seems to stress limited structural reform within the constraints of readjustment in 1982. Local cadres running industrial enterprises might well wonder exactly what the central leadership's economic line is.

Even more sensitive and distressing to local cadres attempting to implement or at least trying to decide whether or not to implement party reform policies must be the central leadership's continual debate over some of the side effects of Deng Xiaoping's liberalizing reforms. The agricultural responsibility systems in the countryside, for example, have led to excesses which have been traditionally condemned. Radio broadcasts from Guangdong Province, for example, say that some districts have not only assigned quotas for agricultural production according to household, but have actually proceeded to divide up the land between families.

The emphasis on the family or the role of the family in agricultural responsibility systems has had some social effects. For example, Guangdong radio says that they have seen a strong resurgence of clan activity for the first time in several years in the south.

Related to this is the resurgence in the countryside of a whole raft of traditional cultural superstitions and beliefs which, to local party cadres who have been trained over the past three decades to destroy the old in Chinese culture, must be absolutely horrifying. These include sorcery, witchcraft, divination, fortunetelling, the sale of women, and arranged marriages.

How local cadres decide to react to these phenomena is a politically ticklish question. On one hand, they have a mandate from the central government to implement reforms which they know are rightist, but they feel uneasy about it because of their questionable historical background. On the other hand, if they crack down on the side effects, they are liable to be labeled as leftists already. So, most cadres just wait and see and do nothing at all.

Other controversies among the leadership itself over other side effects in programs not directly economic but which support the economic reforms have a similarly paralyzing effect on the bureaucracy and the lower level cadres. For example, the Bai Hua affair, in which a PLA author's depiction of demoralization within the party produced a sharp leadership debate in 1981, must have sent shivers down the spines of many cadres.

In summary, I would like to suggest that reform in China and its political context have taken on patterns vaguely reminiscent of the reform cycles in more developed socialist countries in Eastern Europe and the Soviet Union. Scholars of domestic affairs in those countries have observed what they call reform cycles in which oscillating patterns of leadership support and abandonment of reform policies emerge.

Such scholars see party leaderships in countries like Poland before 1980 pressed on objective economic grounds to support various economic and institutional reforms. When the reforms succeed and the economy takes off a little bit, consequences emerge which the party

perceives threaten its own supervision and control. Accordingly, the party clamps down. The economy accordingly declines until the party decides it has to loosen up controls again.

Without pressing this analogy too far, I think it is possible to see in the Chinese situation some parallels for these countries' experience.

So, to summarize overall, I think that Deng Xiaoping's reforms, including those which are intended to open China to more aggressive participation in the world economy, have made impressive headway in recent years. Nevertheless, if Professors Dernberger and Lardy see economic reasons to doubt their longevity, the longevity of the reform programs, I would only add that there seem to be serious internal political problems raised by the reforms themselves which gives cause to doubt this as well. Thank you.

[Mr. Miller's prepared statement follows:]

PREPARED STATEMENT OF H. LYMAN MILLER

POLITICAL CONSTRAINTS ON CHINA'S ECONOMIC REFORMS

The current climate in China favoring the expansion of foreign trade and increased direct foreign involvement in China's economic development is intimately tied to the advance of policies in recent years associated with the Chinese Communist Party's (CCP) reform wing led by Vice Chairman Deng Xiaoping. Although Chinese international economic activities increased steadily since the 1970's as China emerged from its introverted preoccupation with the turbulent politics of the Cultural Revolution, the range and scale of Chinese economic interaction internationally increased dramatically in direct conjunction with the implementation of the whole range of reformist political, social and economic policies advanced by Deng. Maintenance and improvement of this climate favoring increased foreign economic dealings with China therefore rests finally on the overall stability and longevity of Deng's reform program itself.

The reform program advanced by Deng Xiaoping since the death of Mao Zedong covers the entire range of domestic policy. In addition to promoting the expansion of direct foreign trade, the Chinese leadership under Deng has been increasingly ready to adopt foreign economic and business practices to facilitate trade, to acquire foreign technology for Chinese economic development, and to tolerate direct foreign involvement in the Chinese economy through a variety of joint venture arrangements. Typifying Beijing's increased readiness to participate more aggressively in the international economic community are the "special economic zones" established in recent years along the China coast, as well as the designation of several more advanced regions in China to gear their economies directly toward the promotion of Chinese trade internationally.

Paralleling the changes in Chinese attitudes and practices toward foreign economic dealings since Mao's death has been a whole series of reforms in domestic economic policy. In agriculture the Dengist leadership has promoted a number of reforms emphasizing regional diversification and specialization, decentralizing the structure of authority and production in the countryside, vastly expanding sideline plots and enterprises, and promoting rural fairs and markets to facilitate distribution. The hallmark of the agricultural reforms of recent years is the various contracts or responsibility systems put into trial practice in Sichuan and Anhui in 1979 and then authorized for universal application throughout the country thereafter. In industry the reform wing of the CCP led by Deng has begun to promote a wide variety of similar changes, including revision of management practices toward more rational criteria of economic development, the introduction of broad measures of enterprise autonomy in decision-making and profit retention, and the application of responsibility systems into industrial enterprises paralleling those already in place in agriculture.

In the cities the Beijing leadership has tolerated a measure of private economic activity and limited economic "exploitation," both as a means to alleviate unemployment and to fill gaps in the economy which the state and collective economic institutions have not adequately met, most notably in urban services. On a scale

unthinkable in China only 10 years ago, for example, "free markets" have blossomed in many Chinese cities, including Beijing itself, and unimaginable altogether, one may now dine, at a high price, at private restaurants operating in a limited number of homes of Beijing entrepreneurs.

Facilitating these broad reforms in economic policy, practices and institutions have been a series of related institutional and social changes. Various mass organizations, workers congresses and trade unions have been revived or established to promote economic development. Political demands on managers, technicians and other categories of "mental workers" have been relaxed in a new atmosphere sanctioning professionalism and expertise for the sake of economic development. Educational policies have been altered to meet the needs of an increasingly sophisticated Chinese economy, now stressing "key schools" and more rigorously substantive curricula.

As has been frequently the case in the PRC in the past when stress on "redness" has given way to emphasis on "expertise" in the economic and technical spheres, the relaxation of political constraints in the economy has been paralleled by a broad relaxation of political constraints on cultural and intellectual activity. In what has been advertised as a new era of "a hundred flowers blooming and a hundred schools contending," Chinese publishers have poured out a flood of newspapers, periodicals, journals and books addressing the complete range of human intellectual interests. Increased access to foreign knowledge through translation, for example, has been striking. Resuming practices cut off in the Cultural Revolution years, Chinese publishers have begun to turn out a sea of translations of foreign scholarly scientific, political and cultural works, ranging from translations of American and Soviet textbooks on quantum mechanics and general relativity to translations of Henry Kissinger's "White House Years" to illustrated Chinese-language editions of Jane Austen's "Pride and Prejudice."

Accompanying the broad variety of economic, social, institutional and cultural reforms undertaken by the Dengist leadership have been fundamental political changes. With respect to the CCP itself, Deng Xiaoping has attempted to reform the party into a more suitable instrument to guide the rapid modernization of an increasingly complex Chinese society. The heart of these party reforms has been the process of "de-Maoification"—the reassertion of the ultimate political authority of the party organization itself in place of the formerly supreme authority of Mao Zedong and his thought—and the regularization of party procedures and practices. Codes of political conduct have been promulgated to guide the behavior of a generation of party members taught that to "rebel is justified," and discipline inspection commissions have been restored to enforce them. Deng Xiaoping has pressed for a thorough purge of the party apparatus down to grassroots levels, both to root out cadres in power who remain committed to the radical "leftist" principles and attitudes that prevailed during the Cultural Revolution years as well as to make room for cadres inducted into the party according to criteria emphasizing administrative and professional competence appropriate to China's modernization.

Outside the CCP Deng Xiaoping has promoted political reforms similarly directed toward facilitating rapid economic development. The most important of these reforms have included the restoration of 1950's-style united front institutions and practices intended to galvanize support for the party's modernization policies and the reform of state administration for more effective guidance of the nation's economic, technical and educational development. The Chinese People's Political Consultative Conference—the broad united front organization uniting China's various "democratic" parties and front groups—accordingly has been given increased visibility as CCP leaders regularly meet with its representatives in a show of consultation and mutual deliberation. Various reforms in the state apparatus include efforts to separate party and state administrative responsibilities, to reorganize commissions and ministries facilitating coordination and direction of economic planning, production and distribution, and, most recently, to streamline administration and decision-making.

Two fundamental reforms in the style of China's political life have been advanced by Deng Xiaoping for application universally throughout the party and state apparatuses. One has been Deng's stress on the "democratic" half of the Leninist doctrine of democratic centralism. Deng's efforts in this regard have been visible in a wide range of reforms, including revision of selection processes of delegates to party and people's congresses at various levels, the publicity to seeming debate at sessions of the National People's Congress (NPC), and steps to limit tenure by cadres and leaders at all levels. The other major reform in the

mechanics of China's political life introduced under Deng's direction has been the effort to establish law as the ultimate arbiter of political conflict in a rapidly modernizing society. Overturning the Maoist concept that the masses and their advanced political leaders are justified in "kicking aside" party and state leaderships and institutions which no longer represent their progressive interests and aims, Deng and his fellow reformers have promulgated a series of legal codes intended to regulate political and social behavior which are applicable universally to party and state leaders as well as average Chinese citizens alike.

In assessing the prospects for success and longterm longevity of the array of reforms advanced by Deng Xiaoping, three or four important points are worthy of note. First of all, the various reforms Deng put forward are complementary. Taken together they constitute a mutually consistent package of policies and attitudes which reinforce each other. Deng's various political, institutional and social reforms thus are intended to serve the advance of the series of economic reforms he and his colleagues have introduced, all with the broad aim of making China "a powerful socialist and modern country" as rapidly as possible.

Even PRC foreign policy under Deng's direction serves the same end. Chinese connections with the West—especially the United States and Japan—not only serve the PRC's strategic needs but also further Deng's design for China's rapid modernization. Public statements by China's leaders on Sino-U.S. and Sino-Japanese relations accordingly stress the complementary economic needs and assets each side holds for the other in bilateral ties alongside existing strategic concerns in opposing the Soviet Union. Conversely, a strategy for China's economic development which placed less a premium on a role for advanced foreign technology, expertise and capital might accordingly require a more balanced PRC foreign policy which accentuates to a far lesser degree Chinese ties with the West.

To the extent that Deng's reforms reinforce and serve each other, success on one policy front lends impetus toward success on other fronts. The normalization of Sino-Japanese and Sino-American relations in 1978 undoubtedly facilitated the rapid implementation of Deng's reforms in a domestic political context increasingly favorable to him in the same year. The perception of success in agricultural responsibility systems in the years after 1979 undoubtedly lent impetus to their implementation in industry in 1981 as well.

By the same token, however, the internal coherence of Deng's reforms likewise suggests that failure on one or more policy fronts easily translates into setbacks on other reform fronts. Economic difficulties brought on by the very success of Deng's reforms in 1980 thus appear to have been the primary factor in the political confusion among the Beijing leadership in the winter of 1980-1981, when Deng's surging political momentum was effectively stalled and led most notably to the postponement of a series of fundamental reforms in party structure and leadership personnel arrangements. Similarly, tensions in Sino-American relations over the Taiwan question potentially undermine prospects for Deng's economic reforms to the extent that the Chinese leadership is ready to restrict the scale and scope of economic interaction with the United States bilaterally punitively in return for alleged U.S. violations of PRC sovereignty over the island.

The second notable feature of Deng's reform package is that the policies it includes by and large are politically heretical when viewed from the perspective of China's recent history. The broad approach Deng's reform program adopts—employing broad united front tactics and subordinating considerations of political and ideological principle to the requirements of rapid economic modernization—takes as its point of ideological departure the political principles and attitudes embodied in the CCP's 8th Congress of 1956. That congress' policies and the leaders who advocated them were the focus of Mao Zedong's eventual divergence from much of the party's leadership in the years thereafter and of his antagonism during the Cultural Revolution years. Many of the specific reform policies advocated by Deng, moreover, were implemented or experimented with in the late 1950's and early 1960's and were excoriated during the Cultural Revolution. The agricultural responsibility systems, the expansion of sideline plots and the proliferation of free markets now prospering as the hallmark of Dengist agricultural reform, for example, were all introduced in the late 1950's and early 1960's as a response to China's difficult economic situation in the wake of the Great Leap Forward, and all were vilified during the Cultural Revolution as amounting to the reintroduction of capitalism into the Chinese countryside. To a very large extent, therefore, Deng Xiaoping's reform program amounts to a res-

toration of policies and attitudes which had been explicitly condemned for much of China's recent political past as violating the revolutionary principles and traditions on which the regime has been founded.

The politically controversial lineage of many of Deng's reforms naturally complicates their implementation by a party and state apparatus whose cadres retain vivid memories of the Cultural Revolution years. Chinese press commentary describes three types of cadres at lower levels of the party. One type of cadre continues to adhere to the "leftist" principles promoted during the Cultural Revolution years and therefore believes the current reforms advanced by Deng Xiaoping to be "rightist" or "revisionist" and actively opposes their implementation. A second type of cadre firmly supports the current reform policies as politically and ideologically legitimate and accordingly works to implement them. Press commentary describing both of these types of party cadres claims flatly that both represent minorities among the party's lower levels. The third category of cadre, which such press commentary says constitutes the overwhelming majority of the party's ranks, sympathizes with the various reforms promoted by the central leadership under Deng's initiative but remains traumatized by their experiences during the Cultural Revolution. Recognizing the controversial genealogy of many of the reforms, therefore, these cadres hesitate to implement them, cautiously concerned that the current reformist atmosphere at the central level under Deng's hegemony will dissipate in favor of more rigorously orthodox policy approaches and that they will be caught once again carrying out "rightist" policies. Chinese press accounts call this apprehension over the legitimacy of the reform policies the "lingering fear," a debilitating condition among cadres in the party's lower ranks which the press acknowledges persists today despite repeated efforts and assurances by the reformers to overcome it.

A third factor complicating prospects for the success of Deng's reform program is the rising expectations of the Chinese public for a larger direct share of the fruits of China's economic growth. The reformers themselves are responsible to some degree for fueling these expectations. For one thing, steps to increase wages of various categories of workers in the cities and to spur productivity through the use of bonus systems and other material incentives, together with corresponding steps to increase the income of the peasants in the countryside, have contributed to popular expectations of increasing prosperity. Secondly, an academic debate since 1979 on the "aims of socialist production" by reform economists—arguing that economic production under socialism is to benefit the people's livelihood and discrediting the alleged Maoist approach of "making the transition to socialism in poverty"—presaged a reorientation of priorities in Chinese industry toward consumer rather than producer goods in the past three years. This reorientation toward light industry has been upheld despite the depressing effects, acknowledged explicitly in the Chinese press, on the heavy industrial sector this past year.

The concrete impact of this recording of industrial priorities is plain to see in China's capital itself. The variety and color of clothing worn by Chinese in Beijing has changed dramatically in the past year and is a direct consequence of the newly placed emphasis of China's economic planners on producing textiles for consumer use. Many of the clothes worn by the average Beijing citizen are in fact made at home on sewing machines which PRC industry now struggles to produce in adequate quantities and using patterns drawn freehand from fashion advertising appearing in magazines from the West and Hong Kong.

In a context of persistent reformist promises to raise the average income to levels comparable with Chinese workers in Taiwan and Singapore by some year or another and to produce goods increasingly marked for direct popular consumption, the reform wing of the CCP led by Deng is under clear pressure to succeed in its programs. The difficulties in meeting these promises have created problems already and will undoubtedly do so again. When Deng's economic reform program took a decided step backward in the winter of 1980-1981 as reformist enterprise profit-retention schemes exacerbated national budgetary deficits and as inflation outstripped even those wage increases that the state had granted already, an authoritative editorial in the party paper *People's Daily* on January 1, 1981 acknowledged to difficulties of disappointing rising popular expectations:

"In the past, due to our lack of understanding of and consideration for the national conditions and our failure to explain them properly, we made casual remarks and promises and drafted some impractical plans for future economic

development—although we were motivated by the fervent hope to make the country strong and the people happy—and we caused complaints and disappointments among the people because these promises and plans did not materialize." (FBIS China Daily Report, January 2, 1981.)

Repeated failures of this kind in the face of rising popular expectations whetted by the early fruits of a reoriented industrial system can only undermine confidence in the reforms led by Deng and consequently limit prospects for their success.

Such disappointments might be more manageable if the party's prestige and general popular image were not already dimmed. The CCP faces what its own paper *People's Daily* has termed to be a "crisis of confidence" in Chinese socialism, a belief allegedly widespread among China's population and even among some of the party's rank and file membership doubting that the CCP can effectively lead China's modernization. Unspoken cynicism and disillusionment within the party and without—a natural product of the turbulence of political life in China since the mid-1950's—has festered and ripened into what the Beijing press acknowledges to be open disaffection among at least "a small handful" of party members and among wider sectors of Chinese society in recent years. In part Deng's own efforts to legitimize his reforms by asserting the fallibility of Mao Zedong and of the party itself over the past two decades has accelerated this disaffection. In that regard more conservative members of the Beijing leadership who opposed Deng's de-Maoification efforts have been proven at least partly correct in their contention that Deng's steps would disrupt political stability and unity and thereby cripple the party's ability to lead and control. The most visible manifestation of the "crisis of confidence" was the outpouring of criticism of Mao and the party at "Democracy Wall" in Beijing in 1979, although other symptoms of dissatisfaction with the party abound.

Taken together, the various factors outlined above present the reform leadership in China with a serious dilemma. On the one hand the party faces enormous pressures to succeed with its reforms, both to satisfy the rising expectations among China's people and to reconsolidate the political initiative it has lost in recent years. On the other hand these same pressures, together with the economic and social strains that seem universally to accompany modernization in underdeveloped countries, require that the CCP maintain control and insure political stability at all costs. The imperatives in economic life in China require party reform, in other words, and yet reform which is too rapid or thorough is perceived to threaten party control. Finding and maintaining the balance between these countervailing pressures at present remains the CCP leadership's most difficult task.

In a political context in which large sectors of the populace and particularly the majority of lower-level party cadres remain cautiously uncommitted to or unsure about implementing reforms which remain ideologically controversial, if not altogether heretical, moreover, how the party leadership steers a course between the imperatives of reform and control counts a great deal toward the ultimate success of the reforms. A party rank and file and a populace at large still nervous about the political legitimacy of the various reform programs initiated by Deng thus cautiously watches events in Beijing for continual reassurance that the leadership's commitment to the reforms is unflagging. In this larger situation, therefore, leadership consistency of principle and steadiness in implementation of the reforms has been indispensable. Deng Xiaoping accordingly has needed a steady progression of political victories at the center to demonstrate the permanence of the changes he has brought about.

Unfortunately for Deng and the reformers, however, Beijing has not displayed a reassuring consistency of purpose and support for the reforms in recent years. Although Deng has indeed won major political victories in the years since his rehabilitation in 1977, his advance has not been inexorably steady, but rather at times even erratic. Even with regard to the overall orientation of economic development, for example, Beijing has not been unswervingly committed to a single strategy. Thus Beijing set down an almost Stalinist economic development line at the Fifth NPC in 1978, replete with ambitious heavy industrial goals and high production targets. In the spring of 1979 the party leadership abandoned this "New Long March" of the year before in favor of a three-year program to "readjust" serious sectoral imbalances in the national economy. In the fall of 1980, economic reformers ushered in a new policy of pursuing aggressive structural changes in the economy, arguing that the tasks of economic readjustment had

proceeded "better than expected," to use Deng Xiaoping's own words. Only three months later Beijing's economic line changed again, now reasserting the primacy of readjustment over reform and curtailing many of the steps which the reformers had initiated earlier in a new atmosphere of economic crisis. Over the past year reform politicians have only gradually attempted to assert a more limited reform agenda within the constrained economic framework of readjustment. Taking stock of the shifts of line in the past three years, enterprise managers at local levels looking for guidance from Beijing would seem to have every reason to wonder exactly what the central leadership's policy is and to hesitate to implement policies which they believe remain politically controversial.

Much of the wavering in economic orientation, to be sure, is the result of the central leadership's attempt to grapple with unanticipated effects and consequences of their own policies. The upsurge of economic reform through 1980, for example, meant for many selected enterprises an increased autonomy over their own planning. According to authoritative press commentary analyzing the national economic situation at the end of that year, industrial enterprises which had been granted increased control over their own profits and increased powers to formulate their own economic plans for the future reinvested their profits to expand and diversify their own operations without coordinating their consequent increased demand for resources, energy, access to transportation and markets with other, already existing enterprises. In the resulting competition economic production suffered in an overall chaotic economic situation. In addressing the problems in the winter of 1980-1981, the central leadership used the only means at hand—it recentralized enterprise decision-making powers in the hands of the central planning bureaucracy, in effect undercutting the reforms begun only months earlier. Although the reformers had not anticipated the results of their own initiatives (or at least minimized them if they had anticipated them), confusion among local enterprises, and naturally disillusionment with the reforms, was nonetheless the result all the same.

Probably even more distressing to local cadres watching for reassurances of the Beijing leadership's continuing commitment to reforms has been the central party leadership's persisting debate over the anticipated, traditionally controversial effects of the reforms. Instances of this type of debate range over the full array of reform issues, from the recent dispute over the PLA author Bai Hua and his movie script "Unrequited Love" to the party debate in 1980 over the relative danger of "bourgeois" influences on Chinese society versus those of persisting "feudalism." Perhaps most sensitive, however, is the leadership's oscillations on how to deal with the various economic and social effects of the party's implementation of responsibility systems in the countryside. Press commentary since 1980 has thus regularly cited instances where the implementation of such agricultural reforms has gone too far. Thus some districts are said to have not only assigned production quotas according to households within existing production teams, as permitted by the reforms, but also proceeded actually to divide up the land and distribute it among households.

The devolution of the focus of agricultural production back onto the family under the responsibility systems similarly has had predictable but nevertheless controversial social effects. One Guangzhou radio broadcast, for example, acknowledged recently that among such social effects has been a dramatic resurgence of clan activity in Guangdong. Accompanying the renewed importance of family-born social relationships under the responsibility systems, moreover, has been the recrudescence in at least some areas of what veteran party cadres of three decades' experience of efforts to "destroy the old" must regard as a horrifying array of traditional cultural beliefs and practices. Press commentary during this year's Spring Festival, for example, acknowledged that in many rural areas traditional customs and practices which the CCP had long opposed have resurfaced, including geomancy, divination, fortune-telling, arranged marriages and the selling of women.

The party leadership's response to such phenomena has been to renew longstanding party injunctions against them and to call for new efforts to build "socialist spiritual culture" to replace them while persisting in implementing the responsibility systems. Local cadres, however, face what many apparently feel to be a paralyzing political dilemma. On one hand they continue to hesitate to pursue implementation of the reform policies for fear of being accused of encouraging deviation from socialism in the countryside should central support for the reforms falter. On the other hand they hesitate to crack down on the social and

cultural side-effects of the reforms themselves for fear of being criticized as "leftist" by the populace over whom they govern. Most, according to press commentary describing this dilemma, choose to do nothing.

In summary, the reform wing of the CCP led by Deng Xiaoping faces a difficult dilemma. At least some steps toward reform are necessary to meet objective needs in China's economic development. At the same time successful reform has consequences which threaten party control and stability. Wavering and unsteadiness between these twin problems only makes the reformers' task more difficult. To a great degree, the CCP is condemned if it does reform and condemned if it does not.

It seems indeed possible that Deng's reforms, once allowed to gather a momentum of their own, will become a fixed feature of China's economic and political scene. That point has not yet been reached, however, and those who see Dengist reform as an unstoppable trend proceeding toward inevitable triumph might consider the CCP leadership's own modest assessment of support for its reform programs to date, reflected in a PEOPLE'S DAILY commentator article on February 9th of this year. According to the party paper:

"Judging by the actual ideological state of the people at present, among our tens of millions of cadres and party members and among the people as a whole, those who really believe firmly that our country is indeed in a period of great change and development, who believe firmly that our country surely will be able to change from chaos to order and from poverty to prosperity, and who consciously dedicate themselves heroically to bringing about this change, are still relatively few. The great majority of people look forward to such a future, but they have worries of one kind or another, and some people are skeptical, hesitant and wavering; and there are also a very small number of people who are firmly opposed to this great change and development and who want retrogression and the overthrow of the present system and leadership." (FBIS China Daily Report, February 10, 1982.)

Dengist reform in China, from the fundamental overhaul of the party's own institutions to the establishment of special economic zones to facilitate foreign economic intercourse, has a good start, but to judge by the political context in which it has been initiated, its ultimate success is by no means guaranteed.

[ADVISORY NOTE.—The author, who is an employee of the Central Intelligence Agency, wishes to note that the views expressed in this paper are his alone and not necessarily those of any U.S. Government agency or office.]

Mr. SUTTER. Thank you very much, Dr. Miller.

We have seen an impressive number of issues put on our agenda this morning, issues such as swings in American attitudes toward China, issues such as the apparently checkered progress in economic reform in China, and the political overtones of those checkered economic reforms, issues concerning offshore oil as perhaps the most important area of Chinese-American economic cooperation today and in the future, issues such as the implications of less rapid overall economic growth in China in the future for United States-China economic relations.

The participants here have been very patient around a very small table. I think it would be very nice if we took a break for about 10 minutes. Let us reconvene about 10 minutes to 11, and then we can go a little later than scheduled. We can go until about a quarter to 12 with our discussion period.

What I would like to ask our participants in particular to think about is this. First, do they agree with the presentations that have been raised today, and if they don't, please let us know why. Second, what does the current situation in China mean for United States-China economic relations? What do these problems and developments that we have been talking about mean for United States-China economic relations over the next several years?

Let's take a break. We will reconvene at 10 minutes to 11.

[Whereupon, a brief recess was taken.]

Mr. SUTTER. May we reconvene, please?

[Pause.]

Mr. SUTTER. Are people in the back able to hear what is going on?

[Pause.]

Mr. SUTTER. I see that it is a problem. Let me say that the group at the center table will have to endeavor to speak up, so that everyone can hear well.

As we raised a variety of issues this morning, I was wondering if the participants have some comments to make on some of the observations that were brought forth this morning, especially concerning the ideas of swings in American attitudes, ideas of Chinese progress and reform. What does this mean for the United States, Mr. Denny?

Mr. DENNY. Bob, I would like to comment that I completely agree with the main outlines of the remarks of our speakers on the reforms and the future—particularly Bob Dernberger's remarks and Lyman Miller's. However, I wonder if the foreign trade sector is not a somewhat unique animal. Since the middle part of last year, after the June Plenum and Zhao Ziyang's trip to Singapore, the leadership has consistently emphasized development of the special economic zones.

What we see—and I have some examples of this in my paper—are a tremendous interest in all kinds of Chinese organizations. In my judgment, in this last 6- to 9-month period, they have, if anything, gotten even more interested in foreign trade and more aggressive about it. This perhaps is just up to the level of interest, seeking out possible contracts and contract discussions. I would not want to suggest that it has gone as far as an upsurge in actual contracts yet.

Mr. SUTTER. Are there followup questions? Professor Dernberger?

Mr. DERNBERGER. I do not want to cut anyone off.

Mr. SUTTER. Let me explain that the idea is to encourage the remarks of the 12 people around the table for a period of time, and then to open up the discussion to the general audience.

Mr. DERNBERGER. I do not want to disagree entirely, but it is very difficult to translate general policy guidelines in regard to foreign trade to directly relate to trade with a particular country, nor for a particular commodity. I do believe, however, that one could argue that the Chinese have thought of the open economy policy and have rejected that.

It is explicitly admitted that trade will increase faster than national income, that there will be growing foreign trade dependence, but that this trade is to be restricted in the sense that complete plants, while not ruled out completely, are not going to be the main diet.

Mr. DENNY. Absolutely.

Mr. DERNBERGER. In this general overall framework, one could, of course, have growing trade with a particular country. But it is quite clear that the general attitude toward trade has changed considerably in 2 years.

In Zhao's speech he explicitly mentioned several times the problem of assimilating foreign technology in the Chinese economy, and in the section on modernizing industry in China he said that this should emphasize improving the level of technology, but not importing the most modern technology. That is not the way to modernize the country.

There is one comment that was included in my paper, but I did not

mention in my opening statement at the Wingspread Conference, where Chinese and American economists met to discuss development strategies, the poor Chinese had to sit through about 20 papers by American economists spreading a World Bank or open economy view. These papers argued how wonderful that policy is, how horrible the closed economy or import substitution policy is. They were given a steady diet of this theory and empirical evidence for what it would result in, something more like Korea. [Laughter.]

At the end of that conference, however, Xu Dixin, while he may not have understood all of the discussion or theoretical discussion, thanked the Americans for the education they had given him. Nonetheless, thanks but no thanks.

Mr. SUTTER. Mr. Tallas?

Mr. TALLAS. I would like to say that in listening to the four speakers this morning and hearing the points they were making about the economic changes, first one way and then the other that all of these factors have had a big influence on the level of trade and investment, on the level of business relations between the two countries.

I think Dr. Miller's comments about cadres being unsure of which way the political wind is blowing in China has had a very definite effect on their propensity to consummate relationships which have been under discussion and negotiation for quite some time. My own experience in the last 12 months in China is this: Whereas one would hope to find after 2 or 3 years of increasing contacts between businessmen in the United States and their Chinese counterparts that the deals would be negotiated a lot faster, in fact this has not been the case.

I attribute it directly to the fact that the number of economic reforms and political developments within the country have had a major, negative influence on the cadres.

Mr. SUTTER. Professor Lardy?

Mr. LARDY. I have a general comment. I think, although the Chinese are not abandoning the relative opening to the West in terms of trade, I would say that still the general level of understanding of the role of foreign trade is extremely limited. Very few people, at least as far as one can judge, think in terms of trade being motivated by comparative cost. The concept of comparative advantage as the basis for international trade is not a central element in their thinking, particularly on the import side.

The thinking runs much more frequently along the lines of, we are only going to buy abroad what we cannot produce domestically. It is never a question of comparative costs. I think that relatively noneconomic view of the world is reflected even in Zhao's report which was mentioned earlier today.

So I think the prospects are that foreign trade as a share of GNP or other conventional indicators of the degree of openness of the economy are not likely to grow very rapidly under the present regime.

Mr. SUTTER. Mr. Groen?

Mr. GROEN. Foreign trade with China is quite a complex problem, and to try to predict trade based on the political winds, et cetera, is not easy. I think if you look at some of the complexities within China and foreign trade, it may help elucidate the subject.

One of them, presently, is that the foreign trade ministry is sharing, under duress probably but sharing, some of their past responsibility.

Some of the production entities, the industrial ministries, and some of the corporations set up within the industrial ministries are now actually running negotiations for large-scale projects.

Negotiations are taking a long time, and part of the reason they are taking a long time is because, where the expertise in China foreign trade almost totally resided in the Foreign Trade Ministry, now these others who have been in control of production are getting into it. On the one hand they are inexperienced, and on the other there is a struggle between them and the Foreign Trade Ministry's import-export corporations.

So there is a struggle between those two and that tends to slow things down. We see overall changes taking place on the national level. But there is an infighting going on right now which has some implications for the future, that foreign traders can deal more directly with the producers. And as I understand it, the producers are getting control of quite a bit of their own production, whereas they had none before. Now they are wresting control of the price-setting mechanism as well.

So that, just to interject, this trade is quite complex and there are undercurrents in addition to what we see in the press.

Mr. SUTTER. Mr. Sullivan?

Mr. SULLIVAN. Let me say that I do not find myself in much disagreement with what was said this morning. But I think it would be erroneous if people drew the conclusion from this that China tried a system of decentralization and then it did not work, and that it abandoned it and then went back to recentralization.

Maybe as shorthand that is accurate, but what I think has happened is something much more complex, and that is that they decentralized decisionmaking to the point where they found they lost total control, particularly over capital funds, and then they began to institute some central vetoes over certain kinds of decisions at the local level. But I would not call it recentralization.

In other words, to simplify the example, there is quite a difference between telling local authorities what they must make, what they must import, what they must export, which is centralization, and telling them, you can do certain things on your own, there are other things that you have to check with us, and if we let you go ahead and do what you want to do, you can do it, if we tell you you cannot, you cannot.

The other note I would make is this: Zhao Ziyang's comment about technology I interpreted as a very encouraging development, because it represents a realization on the part of the Chinese, which has been growing for the last several years, that there is a lot more to development than simply taking somebody's technology and thinking that you can do something with it.

I visited China in the fall of 1980 when the Chinese were already talking that way at the working level. They even cited the example of the Spey engine which they got from the British in 1973 in a very controversial decision. They got the technology and certain British assistance on how to make the Spey engine, and they said that was a disaster because they did not look at what they could do, how rapidly they could absorb the technology.

They are not buying the latest thing off the shelf, which is what they used to do. They are looking for much more modest things, and I think that is going to be very helpful in their development.

Mr. SUTTER. Mr. Lubman?

Mr. LUBMAN. I would like to discuss a number of points. First, decentralization: This anticipates some of the themes I am going to address later this afternoon, but I wanted to underline what Mr. Groen's emphasis on the inexperience that one often encounters in dealing with new entities.

Sometimes one does not know whether one prefers the habits and mind of the foreign trade negotiators, who have long experience and who like to adhere to the form contracts they have been using for 20 years, or the inexperience and flexibility of representatives of the new entities.

At any rate, the proliferation of new entities, although it means that foreigners can now negotiate directly with producing entities—or end-users if they are sellers—also means that both foreign buyers and sellers have to travel a great deal more than they used to in China. For instance, the head office of a corporation may have previously centralized the role of particular items, but now there may be five branches competing with each other. So does one go to all the five branches in different cities?

These are practical questions that decentralization raises for Americans.

Also, with decentralization, even within the trade corporations subordinate to the foreign trade ministry, creates problems for American importers, of disruption of markets. I think I have mentioned this in my paper, and I certainly will mention now, a number of instances of which I have personal knowledge, in which American importers have gone to China and negotiated contracts under which they have received exclusive rights to distribute a particular product in the United States, only to discover later that branches of the same corporation, newly independent, autonomous and very aggressive, are advertising the sale of those goods in the United States.

~~This has caused not only market disruption, but considerable aggravation to some importers. These problems are not yet resolved. These tugs and pulls are, I think, going to go on for quite a while.~~

On the more positive side, I would just underline Roger's reference to Chinese interest in technology. I think that a potentially fruitful area for American companies is licensing manufacturing technology. A number of American companies have signed contracts in recent years, indeed in recent months, for transfer of technology.

There are problems, for instance the lack of patent protection in China. The Chinese have adopted a draft patent law which has not yet been made public. There does seem to be considerable discussion within China as to whether a patent law should be adopted. Regrettably, some ministries which have been copying foreign equipment and machinery wish to continue doing so. Others wish to import and license foreign equipment, and find patent protection indispensable in such arrangements.

That remains unresolved, although I think within the next year or two we should see a Chinese patent law. I think that issue will be resolved if the present emphasis on selective importation of useful technology is continued.

Mr. SUTTER. Dr. Hardt?

Mr. HARDT. I have several comments in reference to the comparative allusions that several speakers have made. One is in reference to the

interrelationship of politics and economics or broader elements. I think that is a very important comment of Mr. Miller's. Eastern European experience I think indicates there has to be a balance. There has to be a treating together of political, social, and economic changes, which ever precedes.

This goes to the cadre or bureaucracy question that Bob Dernberger mentioned. The secret of Hungary's success is as much in people as it is in the system. The "experts" now dominate over the "reds" in the Hungarian situation and they make the system work.

Now there is a big cadre problem and that is presumably a very difficult problem for China to deal with. It is a current problem in Poland. One sees that everywhere in Eastern Europe and the Soviet Union.

In reference to the question of efficiency, the need of price reform, the need of comparative advantage concepts and so forth, one should remember that the Chinese economy, like the Soviet economy, is a very large economy. What a small economy can do, that is dominated by foreign trade, that is what the Hungarians have done. They have taken the surrogates of the foreign pricing and applied them.

China does not have that option. The Chinese have to have another option. What the other option is is hard to identify. This will pose serious problems in terms of developing more measures of efficiency, because that really is what we are talking about, a system which gives you a basis of establishing criteria for efficiency.

Let me make a third point in reference to foreign trade. It is important for countries that are opening themselves, they have discovered, to understand what in the world is going on in the world around them. If one were to say that if Poland had gone through the same process in the 1960's, it would have been far less of a problem than if it had done it in the 1970's, I think it illustrates the point.

I mean, what was happening in oil prices, what was happening in world recession and so forth. So one of the problems I think China has, is not going too fast into openness, is that they have to become not only aware of comparative advantages, they have to become aware that what happens in the banking community in Frankfurt and other places is going to affect them. They just cannot be impervious to it, and it is very complex and there may be a cost involved in the externalities of foreign trade, which will take a very long time for the Chinese to understand and accommodate to.

Thank you.

Mr. SUTTER. Thank you very much.

Professor Dernberger, do you have a comment?

Mr. DERNBERGER. In the speed with which I gave my remarks, I hope I did not convey the wrong impression. I do not mean to argue that the Chinese have revoked the experimental reform of the economic system. I meant to say that they have put them on hold temporarily while they try to readjust the economy, and once balance is restored they say they will proceed with these.

The whole thrust of my argument, however, is they are going to have a heck of a time doing that, because they are going to run into the same problem over again. When you decentralize, you allow lower levels to use their own initiative and make decisions and they do so in the context of their environment and their own objective function, and that environment is the price structure.

Then when you observe the results of those decisions, you say, we do not like them, they should make other decisions. Then you give them lectures about having the national interest at heart rather than petty profit maximizing. It is impossible for an enterprise manager to have national interests at heart. I do not see how any plant manager can say, well, I am Beijing and have to do the right thing from the point of view of the national interest. He reacts to the prices.

So you would have to have a price reform to get the desired decisions. If you do not have that, then you have to tell him what to do or let him make his own decisions and say, they are the wrong ones, and then step in and reverse them again. That is the point I was trying to make.

Mr. SUTTER. Mr. Holland?

Mr. HOLLAND. I will make a comment in reference to the energy field. The bottom line as I see it is that the Chinese do not have the risk capital which is going to be needed, nor do they have the high technology needed, to develop or to evaluate their offshore resources. Therefore, they want outside input.

I think we will move faster in the energy field than some of these other areas that you are dealing with. I think now that the iceberg is beginning to break up and we are seeing, as Kim mentioned, something come out of China. Oil companies are going to be back making bids within 100 days.

They need us at this point in the energy field, and they are going to take the cash flow, and use it to develop the other segments of their economy that are on land—or on shore—which are much more visible to the mass of people. They will move quickly in the offshore areas now that they have the tax laws and the regulations in place.

Mr. SUTTER. I am getting a general impression that when we look at this in terms of swings in American attitudes toward the Chinese economy, that this group at least is swinging a little bit toward the downbeat side, except for certain areas, oil of course being a very big one. Technology has also been mentioned as a potential bright spot.

We have not mentioned the various types of coproduction arrangements that are being worked with the Chinese, but we will be talking about those this afternoon.

Some of my colleagues here indicate they might have some questions which they would like to ask you. So we will call upon them.

Mr. BAILEY. On that same line, I am interested in asking Mr. Woodward or Mr. Holland what the American oil companies' view of the exploration activities in China is? Are they entering into this enthusiastically? Has it been a very conservative approach to the problem, and how well-informed are the companies, if one can answer that? How do they go about finding the information they need, and would you judge them to be well-informed?

Mr. HOLLAND. I will address this this afternoon in a little more detail. We have all been in there. We spent a lot of time and a lot of efforts as have all the energy companies throughout the world. We have a tremendous amount of data. We have looked at it. We assessed it. We have the tools with which to assess it.

The only thing that is going to happen from this point on, of course, is the drill bit has to tell us whether we are right or wrong. But the potential is great and the risks are great.

I think we have probably not addressed the political problems perhaps as strongly as we should, because we are in a scientific field, and that may be a shortcoming that we (Pennzoil) have. But we have looked at the economic situation and we have some concerns. I think, however, overall, that we are optimistic.

Mr. WOODARD. I would like to add a footnote to that on the question of how well informed the American companies are. It has been my observation—and since I am independent of any of the companies concerned, I do have a chance to talk with them and observe their different positions on this. I think, on the whole, the exploration companies are very well informed. Many of them have specialized staffs that are working on the problem.

On the other hand, there is another wave of support services and activities often that are conducted by very large companies in the petroleum industry. These companies that are coming in for drilling contracts offshore China may want to provide some of the equipment or provide technical services offshore China, they are less well informed and are in a second wave. They are sort of catching up with the exploration companies.

In addition, of course, you do see some variation from one company to the next, both with regard to their assessment of the prospects out there and also with regard to their degree of preparation. Some companies are very optimistic and very forward and have a very forward policy toward China. Others are more reluctant and more aware of the constraints, the hazards and the risks.

Mr. SUTTER. Dr. Hardt?

Mr. HARDT. The numbers you mentioned raise the question of where will the financing come from. This, in the context of my understanding that we are having a little trouble financing the Alaska gas pipeline. Now, is it possible that the market will not have the appropriate funds necessary to finance the kind of ventures that the companies may be interested in?

Mr. HOLLAND. That is going to be a real problem.

Mr. SUTTER. Mr. Tallas?

Mr. TALLAS. Well, as the banker here perhaps I should respond to that. I think it is a valid question. But I think immediately upon reflection the answer is very evident; the financing is available. I have noticed no hesitation on the part of financial institutions around the world to beat a path to doors at the Ministry of Petroleum in Beijing.

We bankers are all aware of the enormous amounts of capital that will be required. We are aware of the industry risks which Mr. Holland pointed to, and we are also aware of the political risk. Speaking for my own institution, we have been aware of that political risk for over 10 years. We have had a strong commitment in the past, continue to have a strong commitment in the present, and will in the future.

For the exploration and production of offshore oil in China, I think the capital is there. I do not think that is a problem.

Mr. SUTTER. Mr. Groen?

Mr. GROEN. What effect has the oil glut had on the urgency of the situation?

Mr. HOLLAND. I think it may turn out to be to some advantage to the oil companies in negotiating with the Chinese at this point. If they had negotiated 2 years ago, we would have been in a much tougher position.

I think right now they realize that we can be a little tougher in the negotiating points on the contracts.

Mr. TALLAS. I would like to mention one other thing that I should have referred to before. At this stage we are talking about exploration and not the amount of capital required for the development of the offshore oil deposits in China. The large amount of capital that we require is somewhere off 3 or 4 years at least. At the exploration stage, obviously the capital which has to be raised is much less.

But the decision to pour in \$30, \$40, or \$50 billion, that decision is one that will be made, as I said, 4 or 5 years from now. It will be based on world oil conditions at that time. It will be based on the results of that exploration.

Mr. SUTTER. Mr. Heginbotham?

Mr. HEGINBOTHAM. I have a follow-up question on that point. Different types of exploration and production contracts impose different requirements on the explorers. It would help to know what the Chinese invitations to bid require the companies to commit to in development work if they have discoveries and who determines whether they are to be commercially developed.

Mr. HOLLAND. Could I ask to have that delayed until this afternoon, because I have some slides that will show some flow diagrams, and I can put forth some numbers for you then.

Mr. SUTTER. Mr. Holland's paper does address that issue in quite considerable detail.

Ms. Locke?

Ms. LOCKE. We saw the Chinese cancel a number of large-scale industrial contracts a while back. My question is are we going to see this kind of behavior again or was it a unique situation?

My second question is addressed to Dr. Dernberger or to Mr. Tallas, our banker. Why hasn't the cancellation of these contracts affected China's creditworthiness or credibility in the international business community?

Mr. SUTTER. Are there any volunteers?

Mr. LUBMAN. Well, on the contract cancellations, I think it is impossible to say that they will never happen again. One can only say that the Chinese have learned a lesson and are very aware of the need to maintain their credibility and creditworthiness.

At first, certainly in early 1979 when the first hints were picked up that things were going to slow down, the Chinese attitude seemed to be—and this is my own personal opinion—"well, we made a mistake." Let me emphasize that the change between 1978 and 1979 was absolutely extraordinary. I spent half of 1978 in Peking and by the end of the year a sign had been put up in the import negotiation building in Chinese asking Chinese not to smoke, because the air had gotten so bad. It was almost impossible to find a negotiating room.

However, by January 1979 suddenly the negotiating rooms began to empty out.

In the spring of 1979 I was back in Peking and was part of a delegation that had a visit with Vice Premier Li Xiannian. His attitude was, well, we really made a mistake. We overbought, but our Japanese friends will understand and will lend us the money to pay for the contracts.

It turns out that the Japanese in fact have done that. So maybe his attitude was not carefree, but was rather a shrewd interpretation of what would happen.

I think that leads me to the second question, and I will let Bob answer that. But before I give up the floor let me say this. Those contract cancellation disputes have been amicably negotiated. One hears that they certainly have been negotiated satisfactorily enough for the contracting parties to remain optimistic about the possibilities of continuing business with the Chinese.

However, if I were advising a client who had a large project in which considerable capital was at stake, I would certainly pay more attention than one used to pay in the past to cancellation clauses. I'll talk a little bit about that later this afternoon.

Did you want to field the other part of the question? It was addressed to you.

Mr. DERNBERGER. What was the other part of the question?

Mr. LUBMAN. It had to do with creditworthiness.

Ms. LOCKE. Will it happen again and why has it not affected the nation's credibility in the financial community?

Mr. DERNBERGER. I guess I am an academic, so I can say whatever I want. A lot of what was reported to be canceled was never really signed in the first place. A lot of what appeared to be a cancellation was the dropping of further negotiation.

There were some true cancellations. In many of these cases I honestly had the feeling that the Japanese asked for it, that they were really pushing hard on the Chinese to sign those contracts, and they were signed without feasibility studies and so on. It has been argued that the Japanese warned them, but the Chinese did not accept those warnings. But when they were canceled they worked it out with them.

So I do not really see any threat to their creditworthiness.

Mr. LUBMAN. I have one brief comment as to where the fault lies for the situation. The term "euphoria" has been used a number of times, and I suppose those of us who specialize in the China trade are saddled with it. It seems to arise in every discussion. Euphoria in most cases, if not all, is usually misplaced. It certainly was in this case.

I would like to point out, though, that the euphoria of 1978 was one which existed on the Chinese side as well as on the foreign side. In 1980 I was talking to a Chinese trade official who asked about what is the state of American business attitudes toward China. I said that a number of American companies are discouraged. He said, yes, that is too bad. I said that in part they are discouraged because you encouraged them in 1978. He said, yes, that is true.

I think that there were in 1978 excessively high expectations about how much could be accomplished, and how soon. I would like to point out also that I think some of that still exists on the part of some of those new organizations which are not quite as experienced in foreign trade as the old foreign trade ministries. And I will talk about that a little bit later.

But as for the euphoria, there has been much more of it. After all, it is a cheap export. [Laughter.]

Also, we have a comparative advantage in that area. [Laughter.]

We have produced much more euphoria than the Chinese, but it has existed on both sides.

Mr. SUTTER. I would like to open this up for about 15 minutes for general discussion. I wanted to raise a question here, but I think this would take at least 15 minutes, so perhaps we can raise it tomorrow morning. It regards the issue of Taiwan and what effect our policy toward Taiwan and arms sales to Taiwan, which was raised by Senator Glenn, will have on our economic relations with China.

But I would now like to open it up for general discussion. Please identify yourself.

Mr. ASHBROOKE. I am Arthur Ashbrooke of the National War College.

I would have thought that after looking at the economy, a very important point would be the clash of the incentives under the agricultural and industrial reforms and the motivation for population control. I think there is a great sacrifice of long-term economic advantage in order to get the short-term gains which Professors Dernberger and Lardy have described.

Mr. SUTTER. Professor Dernberger, do you have a comment?

Mr. DERNBERGER. I wanted to comment earlier on Nick Lardy's presentation, although I don't want to directly disagree with him. He argued that things are working much better in agriculture than in industry, whereas I was generally pessimistic about everything—

Mr. SUTTER. Professor, please speak into the microphone.

Mr. DERNBERGER. Can everybody hear me now who wants to? [Laughter.]

I would agree with what Nick said in the improvements that have been made in agriculture, but they have been made by means of creating material incentives for the peasants and giving them the freedom to make some decisions about cropping and otherwise on their own. The successes, as he indicated, were largely in cash crops and not in grain, and that created a very serious problem because somebody has to grow the grain.

I mean, they can increase the oil crop production and cotton and so forth and get a high growth rate, but if they do not get the grain they are in serious trouble. The peasants, those who did increase grain output, did not sell a large share of that increase to the state. They chose to eat it or to raise pigs or to sell it on other markets rather than to sell it to the state.

Furthermore, the higher prices caused tremendous problems to the state, budget problems, inflationary problems, and so forth. The contract responsibility system created tremendous potential for income differentials in the countryside and made a shambles of their birth control program. And so while it did lead to success during that period, that success was based upon policies that they admit are going to create problems.

Mr. SUTTER. Professor Lardy?

Mr. LARDY. I have a brief comment. I agree with the general thrust of the question, which is that a return to the somewhat more private oriented agricultural sector does create some additional incentives for having larger families. However, it is not clear to me to what extent this will really have a negative consequence in the short run.

Quite frankly, I don't think we really know what the success of birth control programs in the countryside has been over the past decade or so. There is a great deal of indirect evidence to suggest that there is an

enormous differential in the success rate on the birth control program between urban and rural areas, and we will probably have to wait until at least such time as the Chinese release data from their now postponed census to have a better idea as to what extent previous policies have been successful in the countryside.

So I am reserving judgment until we see how successful they have been in the past.

Mr. ASHBROOKE. Well, we could make a general judgment that if there had been momentum toward a successful program in the countryside, any slowdown or reversal of that momentum is extremely important, because of the population-land problem in China and the importance of agriculture for at least the next 20 years.

Mr. LARDY. Yes, I will agree with that.

Mr. SUTTER. Are there other questions from the floor?

Mr. McPHERSON. I am Bruce McPherson, Combustion Engineering. Given the economic bottleneck and the need for technology transfer and so forth to the Chinese economy, to what extent does Peking take a look at or is it starting to expect Washington to provide official developmental assistance or export credits and such? And if those are not forthcoming, what do you see in U.S. trade relations with China? Will they start looking toward other countries for that type of assistance?

Mr. SUTTER. I would just add one point here. We will be discussing this general issue tomorrow morning.

Does anybody want to answer that specific question? Perhaps we ought to leave it until tomorrow. There will be several papers on that issue tomorrow morning, sir.

Mr. DERNBERGER. In my arguments about the reform program, I would set aside the energy sector and the transportation sector for many of those arguments. Those are special sectors that are key bottleneck sectors, and the Chinese I believe have made it explicit that in those sectors they are willing to rely upon imports and they have to, and furthermore they are willing to rely upon loans for imports for those key sectors.

So when you get to those particular sectors, I think the reversal of the open economy policy does not hold.

Ms. MONTAGUE. I am Marion Montague from the Congressional Research Service.

I want to ask about the amount of exploration that the Chinese are now doing. Are they doing very much in this area, in view of the long leadtime that is involved with mining and so forth? Are they exploring and expanding? This is in nonferrous, nonpetroleum mining.

Mr. WOODARD. Well, leaping across the line from fuels to nonfuels, as I understand it, the nonfuel strategic minerals areas is one of the largest areas of trade increase with the United States. Is that correct, Roger?

Mr. SULLIVAN. Yes.

Mr. WOODARD. So that indicates the Chinese would have a substantial interest in proceeding in that area. They already export tungsten and a number of other minerals. I would expect that in those particular areas they would not have a great deal of difficulty getting Japanese or other foreign capital involved in some of their domestic projects on a countertrade basis or whatever.

But I know that Chinese geologists over the years have spent a great deal of effort in trying to pin down minerals that might be of commercial value and that this is now beginning to pay off. I would expect to see more development in this area.

Mr. SUTTER. Are there any other questions at this time? Mr. Wilhelm?

Mr. WILHELM. I am Al Wilhelm from the Atlantic Council.

A few years ago there was quite a bit of talk about the Chinese exporting grains from the south and importing to the north, taking advantage of market differentials. And the comment that they need to be more conscious of comparative costs, et cetera, seems to make small of that particular notion.

Is there any substance to this idea that they play the international market in terms of grain sales, et cetera?

Mr. GROEN. I would address that for a moment. I think before we used to say that they were importing cheap grain, such as wheat, and exporting more expensive rice. I think everybody who has looked at agriculture for a while has been a bit surprised at the new levels of imports into China and how they seem to be sustaining that level.

Part of the reason that they import to these urban areas is because just transporting the grain out of the countryside into the urban areas is a real problem. Once you establish whole distribution systems for grain, it is very difficult to reverse as the urban populations grow, and they have been growing recently, because China does not send people down to the countryside like they used to.

So I think they are having some urban population problems. I personally would not be surprised if, as China becomes more wealthy, it buys more grain. I know for a fact that in the provinces they could use a lot more soybean in their diet. Dofu, which is a soybean product—it is soybean curd—is in very short supply. When dofu comes on sale on the street they queue up and it goes.

In Shanghai I have had some people come to me from Hang Zhou and say, we want soybean, but we cannot give you money for it, but we will trade you for it. I do not now represent a grain company, but I have talked to a couple of them and they are ready to do some provincial deals if the bureaucratic problems can be solved.

So in terms of China exporting expensive grain and importing cheap grain, those will not counterbalance any more. They are going to be deficit spenders in the food area. I think the biggest reason is this established distribution system from the ports. Those beautiful new pneumatic grain unloaders that they have put in will obviously be used for a long time to come.

Mr. LARDY. I have a general comment on that. Their agricultural sector simply has not been geared toward producing commercial grain. The rate of marketing of grain products in particular has declined very substantially compared to the 1950's. Interregional transportation of grain products in the late 1970's is proportionally less than it was in the 1930's.

So it is not so much that they have not had an enormous improvement in their transportation capability. It is just that they have designed alternative systems, relying on imported grain for a very large share of their urban food requirements. Part of this goes back to the concept of self-sufficiency, which lingers on at the provincial level and even lower.

Part of it has to do with the pricing system. The state is unwilling to raise grain prices enough to be competitive with the private market, as Bob Dernberger already has indicated. So given those kinds of constraints, and the continued commitment to supply food to urban consumers at highly subsidized prices, they are in a very difficult position.

They will have to modify their policy on subsidizing urban consumption, extracting grain at below-market prices, or modify their policy on internal transportation and allocate more of their substantial large capacity to the marketing of grains and other food products.

Mr. SUTTER. Dr. Hardt?

Mr. HARDT. There are several people in the audience, Bob, with particular expertise on this.

Mr. SUTTER. Would they care to make any comments on this particular topic?

[No response.]

Mr. SUTTER. It was John's idea. I want you to know that. [Laughter.]

Do we have any other comments? Professor Dernberger?

Mr. DERNBERGER. I cannot remember reading it in Zhao Ziyang's speech, but I think it was in there where he says that we have decided we will continue to import grain in the future.

Ms. GOLDBERG. I am Ruth Goldberg. We can predict—we know that there will be a lot of changes in Chinese policy over the years, modifications according to what the problem seems to be. But to some extent I think that even a more critical issue than exactly what the Chinese choose to do when they face a given problem is how they decide to institutionalize their mechanism for change and make the choices for change. That can be anything from how they make price changes to on what level decisions are made for individual factories.

I was wondering if either Mr. Lardy or Mr. Dernberger could address the question of institutionalization of change.

Mr. DERNBERGER. They have admitted the problem. They have talked a lot about the problem, and they have yet to do it. That is about all I can say.

Mr. SUTTER. I certainly got the impression from your discussion this morning, both of you, that these things are in a state of change.

Mr. DERNBERGER. Well, I would very strongly support what Nick Lardy said about planning. I think all indications are they are working under a quarterly plan. They probably have an idea about the next 3 months, but beyond that it is pretty shaky.

Mr. LUBMAN. But at the same time I think it is important to emphasize that there are encouraging signs of high expectations for the future in terms of institutionalizing change. I note, for instance, as a student of Chinese law, that new laws that are being issued with respect to foreign trade and investment are only part of a great surge of Chinese lawmaking activity which reaches out throughout the society.

For instance, they have just promulgated a law on contracts between Chinese state enterprises, and there seems to be a commitment, at least at the very top, on using laws and regulations to help institutionalize change. That is subject to all kinds of problems that we can talk about perhaps a little bit later this afternoon.

I think that the mere appearance of laws—and I might say this is true as to foreign trade as well as to domestic activity—does not mean

that those laws will necessarily go into practice. That is why I said that the appearance of the laws indicates Chinese expectations and hopes. But that is one response to the problems of institutionalization of change.

Mr. SUTTER. Mr. Tallas?

Mr. TALLAS. I have just one comment which perhaps we can pick up this afternoon or tomorrow morning. I just recall one of the things that Professor Dernberger was remarking on, and that is the way the economic reform or the economic changes have come about in the last 3 or 4 years in China and the fact that this is an evolutionary process.

Most businessmen seem to regard China as a monolith where decisions are made at the top and that is it for the whole country. For a better understanding of the prospects of economic relations between our two countries and all which that implies, we could spend a great deal of fruitful time discussing just how changes are made in China, not so much how they are institutionalized, and reflecting on the fact that some of the major changes that have gone on which we have thought were written in stone turned out to have been positions that had been advocated by one faction or another.

Mr. SUTTER. I think in the interest of time at this point we will have to stop our discussion. Can we take up other points this afternoon? I hope so.

I want to thank you all for your patience. I have a few administrative announcements. First, we will not be meeting in this room this afternoon. We will be meeting in a different room, room 457 in the Russell Senate Office Building.

Second, we have copies of the report which came out of the previous workshop, which Senator Hayakawa referred to, on United States-China military cooperation. If any of you are interested in that, we have copies of that report. They are available up here at the front.

With that, we will declare this morning's session recessed, and we will reconvene at 2:30 this afternoon in room 457 of the Russell Senate Office Building.

[Whereupon, at 11:45 a.m., the workshop was recessed, to reconvene at 2:30 p.m. the same day.]

AFTERNOON SESSION

The workshop convened in room 457, Russell Senate Office Building, at 2:31 p.m., Mr. Robert Sutter (member, Congressional Research Service) presiding.

II. PRACTICAL CONSIDERATIONS IN DOING BUSINESS WITH CHINA

Mr. SUTTER. I would like to welcome you back to our workshop on United States-China economic relations. This afternoon the title of our program is "Practical Considerations in Doing Business With China." After studying the scene and looking at developments in China and what they mean in general for interaction with the United States, we now would like to look at two related issues.

First, we will look at the prospects for specific types of American enterprises, specific types of industries, and specific types of interaction with China. Second, we will discover whether there are some

general rules of thumb that Americans could use to be more effective in their interactions with China.

Our first speaker this afternoon is Gregory Tallas of the First National Bank of Chicago. He was educated in the University of Chicago Graduate School of Business and received his M.B.A. in 1969. He then joined the International Department of the First National Bank of Chicago. He has served in Iran and Australia, where he was country manager. In May 1979, he negotiated on behalf of the First National Bank of Chicago the first direct term loan by a U.S. bank to a borrower in the PRC.

Mr. Tallas, please.

STATEMENT OF GREGORY G. TALLAS, THE FIRST NATIONAL BANK OF CHICAGO, CHICAGO, ILL.

Mr. TALLAS. Thank you, Bob.

After sitting through this morning's session, I find that most of what I was going to say this afternoon in the time allotted to me already has been said, but I think this afternoon the focus should be more on what is right in China or in China trade with the United States, and I hope perhaps to bring a different perspective.

There is no doubt that there are enormous problems in China, in the bureaucracy, and in the efforts of the Chinese to suddenly open their doors to economic relations with the rest of the world after 30 years of minimizing those contacts. This morning, we heard about the fact that in the area of economic reforms and policy, that there is an evolutionary process in China rather than, as I mentioned toward the end of the session, a situation where we have a monolithic government structure and where at any point in time policy, procedure, and regulations are known with certainty throughout the country.

I think, given the fact that the Chinese are in a readjustment period, which is to say a reassessment of the practicality of their economic program, it is a good time for us as well to be reassessing the prospects for trade and investment between our two countries. We already have been told that there was a euphoria 4 years ago, in 1978, the period to which I refer as "bright new horizons." Now we seem to have fallen into the opposite role, and people talk about "doom and gloom" when they refer to the market opportunities in China, and indeed some people say that the bloom seems to be off the rose.

Well, what is the truth of the matter? Are the prospects for trade and investment between our two countries bad? Are we looking at a situation where China will not be a large market for U.S. goods and services? If it is going to be a big market, when is it going to be a big market? I for one think that the prospects for continued increase in trade and investment between our two countries is still very strong. I think the opportunities and the prospects for trade and investment have always, even in 1978, been positioned somewhere between the two extremes.

I note that in the 2 years, before last year, trade between our two countries had doubled, and although the figures for 1981, which were just released, show a slight decrease in total trade, the figure is rather substantial. As a matter of fact China's exports to the United States have increased, substantially reducing the trade deficit which it was running with the United States, which was a cause of great concern.

I mentioned before the word "perspective," and I think in assessing the future of trade and investment between our two countries, that word should be used as a guideline. There was the situation in 1978 when China opened its doors to trade and investment with the world, and called for massive imports of technology and foreign services to help in an economic development program. This was a major shift, a major change from what had transpired over the previous 30 years.

I recall that when I first went to China in the fall of 1978 as a banker, it was impossible to talk about loans. There was no such thing as loans. China didn't take loans. But if they take foreign credits, they were going to take them on a government-to-government basis. A year later, our bank was fortunate to make a term loan to a borrower in China. Things have changed in China enormously over a very short period of time.

I think if we keep remembering that it has only been since 1978, really, that there have been extensive business contacts between the two countries, we will certainly come to the conclusion that what has transpired in the past 4 years is a rather substantial economic relationship which has good prospects of continuing.

In the euphoria which Stan Lubman mentioned was hyped a little bit by the Chinese themselves, the U.S. business community looked at China as an emerging new market, as another market similar to the Middle East. Saudi Arabia somebody mentioned this morning. Well, it certainly is a large market, much larger than Saudi Arabia, given the fact of its population, but of course China does not have an enormous foreign exchange income from the sale of a commodity like oil.

The question of whether we have really been successful in business relations or economic relations with China in the last few years, is really a function of what one's expectations are. If one had expectations that this was a market very similar to others in the world, where companies could travel to China, sit down and maybe after a month or 6 months negotiate a \$1 billion deal, if that was the expectation, then it was bound to fail, and fail it did.

On the other hand, if one had the perspective of what had transpired over the previous 30 years, the fact that at the same time the Chinese were opening their doors to foreign economic contacts, they were making major changes in the bureaucratic structure and their economic system, enormous political changes, then one's expectation certainly would not have been as large.

In some respects, given some of the successes of the last few years, one might wonder at why there has been so much success rather than asking the question of whether there hasn't been too much failure. I think much has been made of the difficulties of negotiating with the Chinese. Those problems have been all too real, as have been the accompanying frustrations, but the real problem of U.S. companies in the past and in the present is the ability to focus on what is the market for a company's goods and services, where is that market in China, and how to reach that market.

What is important in approaching China is to prepare a rather long-term strategy. If one knows exactly what one wants to do in China, where one wants to be in trade relations with China over the next 3, 5, or 7 years, and is willing to sit down and determine just how much investment one is willing to make in the development of that

market, I think we wouldn't hear as much complaint about China being a difficult and costly market in which to do business.

One of the important points to make about the future of business relations between the two countries is what the Chinese have in mind when they speak of closer economic relations. I am reminded of this again by the latest promulgation of the regulations on oil exploration and cooperation. It is quite clear that China would like to invite firms to do business with China and not in China. This is to say the emphasis is on companies who will cooperate with China, cooperate with Chinese enterprises, and the benefits will be not only profits but an ability to reach the domestic market.

I think it very unlikely that there will be much success in U.S. companies being able to tap that rather large domestic market of almost 1 billion people. What is possible is for U.S. companies to be able to enter into a contractual relationship, a joint venture or otherwise, which will give them some access in an indirect manner to that large consumer market.

To close my remarks this morning, I cannot help but comment on the question of the importance of political relations. I don't think there is any doubt that deteriorating political relations between our two countries will have an effect on trade relations. Every indication over the past 4 years of how China conducts its foreign trade indicates that the political factor always is present. On the other hand, I am not willing to hazard a guess as to what effect deteriorating political relations would have, but there would be some.

I think the argument that some would make that the United States is more important to China than China is to the United States is mistaken. If we are talking about forming a relationship with a country of 1 billion people in Asia, it is not much of a relationship if we are going to talk in terms of that relationship being more important to one side than to the other.

Thank you.

[Mr. Tallas' prepared statement follows:]

PREPARED STATEMENT OF GREGORY G. TALLAS

It is a particular pleasure for me this afternoon to participate in this workshop and to address a subject for which I and my colleagues at the First National Bank of Chicago have dedicated considerable resources for quite a number of years.

First Chicago first began doing business with China as early as 1974 although our efforts to establish a long-term relationship with China began many years earlier. In January 1978, First Chicago established the first full U.S. bank relationship with Bank of China, a relationship which it uniquely enjoyed until 12 months later when similar relationships with other U.S. banks were established. Our relationship in China has been expanded and considerably strengthened since that time. In 1979, we were the first U.S. bank to lend directly to a Chinese borrower and in 1980, First Chicago opened the first U.S. Bank Representative Office in Beijing.

We are a joint venture partner with the Bank of China and the Industrial Bank of Japan in a merchant bank in Hong Kong, CCIC Finance Limited. Our business extends not only to providing financial services for U.S. customers in the China market but we are fortunate to count among our customers a number of Chinese companies and agencies.

At the present time, China is in the middle of a "readjustment period" in the major economic development program which was announced 4 years ago by the the Chinese Government. This readjustment is an opportunity for China to re-

assess the practicality of the development program and match that program to economic conditions as they really exist to the country. This readjustment has been interpreted by some as an indication that China is not the major market that it once appeared to be. Accordingly, it is an appropriate moment for us here today to be conducting a reassessment of the prospects for trade and investment between the two countries in the years ahead.

The announcement of the "Four Modernizations" in 1978 as the foundation for a modern China was accompanied by plans for major capital investment projects in the resource and heavy industry areas of the economy.

These plans were announced at a time of rapidly expanding commercial and industrial contacts between our two countries after many years of little meaningful economic relations. The influence of these announcements on the U.S. business community was all the greater when in January 1979, diplomatic relations were reestablished between the two countries.

In the few years that followed, the painful realities of economic infrastructure of the economy, have combined to lead China to make several changes in its development program. These changes have resulted in a more realistic program but at the same time, they have resulted in project deferrals and some contract cancellations, the latter requiring expensive payments for damages.

By some accounts, the U.S. business community's perception of China as a market has gone from what had been described as "bright new horizons," to an image best described as "the bloom is off the rose."

In point of fact, the prospect for increased Sino-United States trade and investment is still very strong and the opportunity has always been situated somewhere between these two extremes.

Much has been made of the dissimilarities in culture in discussing the difficulties met by U.S. businessmen doing business with China. However, the facts are that China is no more exotic a country than a number of others in the world where U.S. corporations successfully compete and do business on a profitable basis.

What is true is that, not only is the U.S. business community new to trade relations with China, unlike their European counterparts, but China, at the same time has newly opened itself to major trade relations with the world, unlike the period prior to 1978 when foreign trade was very low. An appreciation of all that the latter event required in the way of changes in China would lead one to expect a number of obstacles. Indeed, there have been in the past few years a number of difficulties and barriers to successful business relations but many of these have fallen away as a result of joint attention by both governments.

It has only been four years since China announced it would seek foreign capital and technology to support its economic development. Prior to that time, the Government had repeatedly emphasized its total opposition to such foreign contributions.

It is important to keep the record of trade and investment with China within a perspective that includes the substantial social and political changes that have occurred in the country.

When one considers conditions in China as they existed for the visiting businessman in 1978 and what exists today, one is impressed with the enormous change that has occurred particularly with regard to the business environment. This is not to minimize past and present difficulties or frustrations but business success or failure is very much a function of expectations. Most expectations were unfortunately formed without an appreciation of the total environment for relations with China. For 30 years, China remained a relatively closed market for the industrialized West and conducted its foreign trade at a level well below that of today. The economic system deteriorated under rigid planning and direction by the Central Government.

In light of these conditions, it is hardly surprising to find that China was ill-equipped to handle the flood of trade and investment contacts that came after 1978.

Just as the economic infrastructure was proven inadequate to support the substantial increase in capital investment, China's foreign trade organizations and enterprises were initially unprepared to deal quickly and consummate trade and investment relationships with foreigners.

The number and complexity of transactions with foreigners immediately began to overwhelm the bureaucracy which existed in 1978. Decisionmakers in China were concentrated at the top of the bureaucratic structures. There was a major

shortage of qualified personnel to review proposals from abroad. At the same time, political change was underway which was not without effect on the ability of China to deal effectively with Westerners. Some of the effects of those conditions are still at work although they are decreasing over time.

One of the biggest barriers to trade and investment in the past has been the lack of a legal environment in which U.S. firms can invest. There was neither a legal code in China nor appropriate laws and regulations covering foreign transactions. Most foreigners, therefore, required that Western law be the governing law of their contracts. However, there were few in China who had any knowledge of Western law, and these terms were resisted by China. In retrospect, one is impressed with how much in the way of business was accomplished rather than how little. Indeed, a number of companies have succeeded quite well despite such obstacles as these during this period.

Many companies have complained, and rightly so, that negotiations have taken an inordinate length of time. The cost of protracted negotiations coupled with what appears to have been attractive business opportunities elsewhere in the world, has resulted in China being viewed as a difficult and costly market.

The propensity for one's Chinese counterparts, for whatever reason, to engage in decisionmaking by committee has been a large problem for U.S. companies expecting quick decisions. Frequently, the decisionmaker(s) are not present as negotiators. Long negotiations are the result.

There is the suspicion that long negotiations have resulted from premature expressions of interest by Chinese parties as well as their unstructured approval process. The businessman is accordingly kept negotiating endlessly while these problems are resolved. Over the past few years, however, the Chinese Government's program to push economic decisions and authority down to the Province and Municipality level of government has improved the situation.

Doubtless, the bureaucratic realignment currently underway in China will also have a favorable influence on a China's ability to conduct its business affairs closer to the form expected by foreign businessmen. My experience in negotiations over the last 4 years in China has been mixed. In some cases, negotiations have been concluded in as few as 5 days while others have continued for as long as 24 months without a successful conclusion.

Despite these types of problems in the past, which have been all too real for U.S. companies, the real problems that U.S. companies face in doing business with China is less a question of how to negotiate successfully in China and more a question of what is the market for a company's product or service, where is it, and how to reach it.

At the same time, many companies have approached the market with unrealistic short time horizons. In many cases, prudent business practices were ignored in the belief that the way of doing business in China was substantially different than doing business elsewhere in the world.

There have been quite a number of disappointments by U.S. companies over the last few years in China but at the same time, there have been many success stories. As is usually the case, those who were disappointed are more apt to publicize their disappointments than those who are successful and intent on keeping their success as quiet as possible while they continue to pursue opportunities without competitive pressure.

The characteristics of a successful company in China are several. The pursuit of relationships in China usually began several years ago, in many cases, preceding the establishment of diplomatic relations between the United States and China. If not right from the beginning, then soon after entering the market, the company prepared a strategy for its involvement in China and has been pursuing it for several years while managing its annual investment in market development.

Successful relationships began with small and simple transactions and proceeded to larger transactions. In a few cases, success has come in a short period of time although this is the exception.

If results have been too few, as in the eyes of many, then equally, expectations were far too high in the past. Total trade between China and the United States decreased slightly in 1981 after a rapid expansion in the 2 previous years. However, the substantial trade deficit which China has been running with the United States narrowed in the past year and if the trend continues, it can only bode well for an increase in exports from the United States.

The export of large amounts of agricultural commodities is likely to continue in the near term in accordance with programs announced in China. While these

commodities will continue to be a major part of our exports to China, I believe that their percentage contribution to total exports will decline in the years ahead reflecting the broadly based growth of our trader relationship.

One of the brightest opportunities for U.S. industry in China is in the energy area. The exploration and production of offshore oil and gas has one of the highest priorities in China's economic development plan. The development of offshore deposits will be a lengthy process requiring not only large amounts of capital from abroad but also import of technology and services.

The technology and experience required for this effort to develop energy resources would indicate that not only oil and gas producers but service companies will find a large opportunity in China in the years ahead. I do not believe that the near term holds much promise of access to the Chinese consumer market since the foreign exchange required for such imports is in short supply and has a much higher utility on the purchase of technology and capital goods.

There is no doubt, however, that the Chinese Government is very much concerned with raising the standard of living and meeting the expectations of the world's largest population, over 60 percent of which is below the age of 30 years. While direct access to the consumer market in China is not likely, many firms will find attractive opportunities to enter into joint cooperative ventures in China which will offer indirect access to the consumer market.

One thing appears unclear and is reflected time and again in new regulations that are promulgated in China with regard to commercial and industrial relations with the rest of the world. Generally, China is not ready to allow companies to conduct business directly in China and is committed to programs that channel interest of foreign companies toward cooperative undertakings and doing business with China. An appreciation of this distinction will be helpful to companies contemplating opportunities in China. While this program may not be novel for a communist country, the extent to which the government in Beijing is committed to such a concept and the scope contemplated, is unusual.

To build its industrial capacity and to rapidly develop its economy, China has few alternatives but to rely on technology from abroad. The utilization of foreign capital as well as foreign technology has been affirmed by senior officials in China many times in the past 3 years. However, the capacity of the country to absorb foreign technology and efficiently utilize foreign capital has been acknowledged to be less than what had been planned in the past. This is a major concern in China today.

Therefore, the opportunity for billion dollar sales to China within a short period of time is not real, although one should expect a strong continuing growth in total trade. But United States-China trade faces a number of problems in addition to the obvious question of how China is to pay for these imports. The terms of cooperative ventures through which China hopes to obtain technology have been unfavorable to U.S. companies reflecting an unrealistic value placed on the technology or perhaps reflecting the inability to value foreign technology in a non-market economy. Additionally the Chinese concept of importing technology to expand foreign trade which in turn would pay for more technology imports, is predicated on access to world markets including the United States. These markets are in some cases already served by U.S. companies which are not eager to equip a new and major competitor who will appear in these markets at some future date.

With expressed concerns over past foreign trade deficits and its conservative economic policy, China plans imports that will grow only as fast as China's exports generate income with which to pay for them.

A strong supportive role for the U.S. Government is essential for fostering trade and investment. Recent efforts by our Government to expedite the handling of applications and issuance of export licenses for high technology exports are especially welcomed. Applications for export licenses will most likely increase in the future given China's development needs and economic policies. A definitive U.S. policy on what technology will be available to China would be an important contribution.

A second important area is the availability of export credits to support U.S. manufacturers' sales to China. With foreign exchange in short supply, it is hardly surprising that China continues to be very price sensitive particularly when it comes to financing its imports. The availability of a strong export credit program at the U.S. Export-Import Bank is essential if U.S. companies are to compete successfully with foreign firms which are well armed with such credit facilities when pursuing sales in China. Early action on the review of

the new PRC tax regulations to determine the creditability of PRC taxes against U.S. taxes is a major requirement for U.S. companies pursuing opportunities in oil and gas exploration and production in China.

Of particular importance is the removal of barriers that restrict China's access to U.S. markets. As an underdeveloped economy, the range of goods which China can realistically expect to sell in the United States is quite limited and far less than what it would like to buy. In the past, China has been particularly sensitive to the large trade deficits with the United States and growth in U.S. exports to China can only occur simultaneous with growth in imports from China.

No assessment of the future opportunities for U.S. business in China would be complete without addressing the importance of political relations. Deterioration of diplomatic relations between the United States and China would not remain unreflected in trade and investment relations. While China might turn away from the United States as a supplier, U.S. companies would certainly curtail their investment plans. While it cannot be refuted that the United States has much to offer China in its economic development, I don't believe that this is a factor which would shield trade relations from the influence of deteriorating diplomatic relations. A relationship in which one side feels that such a relationship is more important to the other is not a strong basis for investment.

The question of what effect would be felt from a deterioration in diplomatic relations is a difficult one to answer and I for one would not hazard a guess on this subject.

As an example of how political considerations can affect economic and business decisions in China, I would relate a situation recently described to me by a major U.S. corporation. After several months of increasingly intense negotiations, this company was in the last stages of signing a multi-million dollar contract with a government agency in China. This was during the time of contract cancellations and project deferrals that had affected several large Japanese companies. At the last stage, where discussions concerned only minor technical points in the contract, the company was informed suddenly that the contract was to be awarded to a Japanese supplier. The company could only surmise that the last minute change to a Japanese supplier was done for political reasons, perhaps to offset the damage done to economic relations with Japan from prior contract cancellations.

Whether the surmise is correct or not, I think there are other examples of the effect of political considerations on China's trade relations to which we can refer.

Mr. SUTTER. Thank you very much, Mr. Tallas.

Our next speaker will be Stanley Lubman. He is a partner in the law firm of Heller, Ehrman, White, and McAuliffe, San Francisco and Hong Kong, specializing in international matters, particularly those involving the PRC. Since 1972 he has been involved in extensive negotiations in China on a wide range of transactions, including heavy capital goods, high technology equipment, large-scale engineering services, and other matters. He was educated at the Columbia Law School, and he has been a professor at the School of Law at the University of California at Berkeley.

Mr. Lubman.

**STATEMENT OF STANLEY LUBMAN, HELLER, EHRMAN, WHITE,
AND McAULIFFE, SAN FRANCISCO, CALIF.**

Mr. LUBMAN. Thank you, Bob.

In the 10 minutes I have, I would like to first summarize briefly the main points in the statement that I have prepared, and then emphasize some perspectives which American business might usefully adopt in considering the China trade.

My paper addresses itself to three principal notions that I think are important to keep in mind in an overview of the China trade; namely,

bureaucracy, law, and negotiations. These are at any rate the three that seem to make up most of the matters that concern me about trade and investment in China either when I am in China or away.

First, is bureaucracy. It is essential to keep in mind that, as Greg Tallas said this morning, China is not a monolith. Gone are the days when one could ever think of it as a monolith. There is not one China, but many Chinas, in fact. Since 1978, the Chinese foreign trade bureaucracy has been very greatly reorganized. The foreign trade corporations which once monopolized China's foreign trade have been decentralized, so that the branches of those corporations have much more autonomy over their transactions than they previously had. In addition, the Foreign Trade Ministry has lost the monopoly it once had, and there has been an unceasing proliferation of new corporations and other organizations with authority to engage directly in negotiations with foreigners.

For instance, almost every ministry of machine building now has its own foreign trade corporation, to name one example. Autonomy has been granted to a number of provinces, Guangdong and Fujian in particular, and the cities of Shanghai, Tianjin, and Beijing have also been exercising great autonomy. The result has been what I find to be an extraordinary flux and frequent confusion, not only on the part of foreigners but on the part of Chinese themselves.

I am reminded, perhaps irrelevantly, of a famous weather report. Croucho Marx used to talk about high winds, followed by high skirts followed by me. [General laughter.]

Somehow, that litany comes to mind. I think of decentralization, followed by recentralization followed by me or other Americans trying to find out where to go.

The problem, as I have said, is not only events on the American side of the table, that is, the foreign side, but on the Chinese side as well. Because of this proliferation of new bodies, there has been a diffusion of power and a spreading of authority which often makes it difficult, for instance, to find out which organization has the power to enter into an agreement and to identify the organization which has the power to approve that agreement.

It is most curious to go to Beijing and be told by one organization that it must approve a particular transaction that is contemplated elsewhere in China as, for instance, in Guangdong, and then go to Guangdong to be told by Guangdong officials that nobody else outside Guangdong has to approve the transaction. These confusions have arisen, and to my knowledge persist. I also think they will persist for at least a while.

In addition to the bureaucratic explosion there has also been an extraordinary proliferation of new types of transactions. It used to be before 1978 that the China trade was just that. It was trade in products that came in boxes, bundles, and bales, and the purchases were essentially for cash on either side.

Since 1978, we have seen the appearance of Chinese hospitality to foreign equity joint ventures. There are now around 30 joint venture agreements which have been approved. Only one is a heavy industrial one. About half are hotels. Most of the rest are light industrial or textile joint ventures. There is currently in China a very strong emphasis on permitting joint venture investment. The rather general and

brief joint venture law which has been supplemented thus far, incompletely, by several sets of regulations is soon to be supplemented by what the Chinese tell us will be comprehensive implementing regulations.

The Chinese intend to discuss some 150 projects at a meeting which they are convening with the assistance of UNIDO in June 1982. In addition, the Chinese have created export processing zones, called special economic zones. There are a number in Guangdong Province, a number in Fujian, which have exhibited the most extraordinary autonomy in foreign trade. Most of the billions of dollars already invested in those special economic zones, the most important of which are just across the border from Hong Kong, have been invested by Overseas Chinese. Several U.S. companies already have signed agreements to establish facilities there, one of them being Pepsico, which will establish a bottling plant in Shenzhen, and several other American companies as well.

Among the other transactions which now have become possible are coproduction and so-called compensation or countertrade transactions. There has been a marked increase on the part of the Chinese in pure licensing of manufacturing technology. A number of U.S. companies have engaged in licensing transactions. Others are under discussion.

I am convinced quite strongly that with the acceleration of the offshore exploration efforts, the Chinese, in order to be able to have competitive equipment to sell to the foreign companies, will be extremely interested in licensing oilfield equipment for manufacture. There are problems, such as the present lack of patent protection, and some difficulties in standard Chinese contracts, but I do see a strong and continuing Chinese interest. So much for bureaucracy.

As for law, as I said this morning in response to Ruth Goldberg's question about Chinese interests in institutionalizing change, there has been an outpouring of new Chinese laws. In addition to the laws on joint ventures we have seen sets of laws appear on taxation of joint ventures, individuals, and now on foreign economic activities other than joint ventures. Regulations supplementing this last law have just appeared. There are more laws to come.

An essential question so far as the legal system is concerned is how soon will those new laws begin to stabilize the expectations both of foreigners and Chinese officials? I see this happening only very slowly, and I think we would be very wrong to place a great deal of faith very soon in the Chinese legal system. For one thing, as Lyman Miller mentioned this morning, shifts in policy are political constraints on economic change. They certainly can obviously erode the basis for enforcement of the law.

Also, these new laws, although nationwide in effect at least on paper, take a while to percolate down not only to the desks of the bureaucrats who must enforce them, but also into the mentality of bureaucrats who for the last 30 years have not been accustomed to using legal rules to guide their dealings either with each other or with foreigners or with Chinese.

Consider, for instance, the various roles that law may have in a society. It can be a tool for discipline, which is a function often mentioned. Westerners very often also like to think of laws as creating

rights. We have yet to see the successful institutionalization of the law as a mechanism pointedly intended to vindicate rights asserted by foreigners or Chinese against the Chinese state. Also, there is a lack of resources, that is of law-trained personnel, who are available only in very small numbers.

The third element I want to stress is negotiations. Much has been said about how slow and wearying they can be. I want to talk about a number of practical considerations. I think that there has been an overmystification of the China trade. I think also, for some strange reason—after 10 years in the China trade, I still find it impossible to explain—a suspension of judgment often occurs when foreigners go to China.

Let me quote a statement which was written by an experienced American businessman, published in November 1981. Now, this is not November of 1971, but November of 1981. The writer says that in China the seller must adjust himself to the procedure of the Chinese, who establish the agenda, change the topics, and pace the negotiations. The seller must stay in China as long as the Chinese consider it adequate.

Now, I regard that advice, if literally taken, and there is no qualification, not only as pernicious, but as potentially devastating to the balance sheet of any U.S. or other foreign company that followed it. Rather than think that the Chinese must control the negotiations, it seems to me—and in practice this happens all the time—that the foreign company must try and influence its negotiation.

Both sides must have some idea of their expectations before they negotiate. Both sides also know that they will be the prisoners of past Chinese practice and the Chinese bureaucracy. There is nothing wrong with collecting information before an American company goes. Your friendly banker would obviously be glad to provide it.

There are many other sources of information, such as the National Council, the Department of Commerce. Indeed, there is more information about the Chinese economy than most businessmen normally assume exists. It is possible to collect it, and actually to form some educated guess about the relevant sector of the Chinese economy, and go knowing what it is you want to do.

I would disagree slightly with Greg Tallas; I think it is rather hard for a company to form a plan for the next 5 to 7 years. I would rather start with the next 1 to 2 years. But certainly I agree that one should plan. Not only that, when one plans for a specific negotiation, one should try and find out through one's own representative on the spot before one goes whether the Chinese organization has the authority to negotiate, what alternatives there might be, and what expectations they have of the transactions. As I indicated this morning, sometimes exaggerated expectations can be on the other, Chinese, side of the table, particularly when the organization is a new one.

Normally, the Chinese will want to have technical negotiations first. It is possible nonetheless to get some idea whether there is some commercial basis about which the two sides have common assumptions. It is to me astounding that many foreign companies still come to China without having done this elementary preparation.

Now, no matter how prepared one is when one gets there, one finds certain characteristics of the Chinese negotiating process. As a lawyer,

I can assure you that it is true that the Chinese have an aversion to legalisms. They also have an aversion to lengthy contracts, and they also don't like to talk about what American lawyers very often like to talk about, that is, what might happen if performance by one party of its obligations is somehow interfered with, or if there is a breach on one side. The Chinese prefer to talk about how successful the transaction may be, and how it may lead to other transactions.

However, although they don't like legalisms, the Chinese negotiators I have encountered are perfectly willing to negotiate the substance of an agreement. Although they dislike lengthy contracts, and many American companies do like lengthy contracts, they are sometimes far too long for the situation. Also, although neither side really wants to spell out perhaps each and every consequence of breach, it is nonetheless possible to negotiate an agreement, perhaps compressed, that will effectively summarize and protect the expectations of both sides.

Let me close this by suggesting a perspective: The Chinese very often say, "You must take into account our special situation." Well, the situation of China, if one steps back, is not that special, in the sense that China is a developing country saddled with a large, rigid bureaucracy. That is not a situation unique in the world, and it seems to me if you adjust your expectations to that situation, as Greg emphasized, it is possible to have realistic expectations.

Another way of looking at Chinese law is suggested by Lyman Miller's reference this morning to a number of interesting phenomena such as the reappearance of old traditional practices. This is very common, certainly, in developing countries. In traditional societies, allegiances are local, particularistic, smaller in focus than on a nation. China is still in the process of forging values and standards which are nationwide. They do not totally permeate the society, and one should expect variations.

So far as the stability of expectations is concerned, I think they will gradually increase. If you look back 10 years ago, when Americans first began coming back to China in 1972, trade was not very complex, and possibilities were much more limited than they are today. If you look now, you can see from the perspective of the last 10 years that possibilities are developing, and there is a considerable determination still on the part of the Chinese leadership to link China with the international economic order in order to further China's economic development.

The implications of what I have to say are really very simple. I think American business must now go to China prepared and informed, as it is possible to do.

Some last concluding points are simply these: It is not necessary to do concessionary business in order to stay in the game. I think one of the rules of the China trade is that he who does business the first time to do concessionary business and get his foot in the door, will get his nose caught in it the second time.

I think it is not necessary to abandon normal prudence and caution. I also think it is necessary to be flexible, particularly in view of the lack of foreign exchange. It is necessary to be flexible also in terms of documentation of terms. Negotiations are long but transactions have beginnings, middles, and ends, and negotiations have been successful on both sides when these basic principles have been followed.

Finally, although I have tried to avoid some of the cliches of the China trade, I have to end by urging patience, I am afraid. It seems to be necessary, as is a sense of humor. Thank you.

[Mr. Lubman's prepared statement follows:]

PREPARED STATEMENT OF STANLEY LUBMAN

BUREAUCRACY, LAW AND NEGOTIATIONS IN CHINA'S FOREIGN TRADE

This paper emphasizes three themes which seem most important in an overview of China's foreign trade. The pages which follow discuss each in turn.

CHINA'S FOREIGN TRADE APPARATUS

In recent years Chicago's foreign trade bureaucracy has been so thoroughly reorganized that persistent disorder has been created. The decentralization of authority to engage in foreign trade transactions, the proliferation of new bodies engaging in such transactions, and the resulting diffusion of power have created problems which often puzzle Chinese officials as much as foreigners. Neither flux nor puzzlement are likely to end soon.

Organizational changes

Most dramatic of all has been termination of the monopoly which the Ministry of Foreign Trade and its trade corporations once exercised over China's foreign trade. A small number of trade corporations handled *all* foreign trade transactions. Functionally divided by commodity and centrally directed by the Beijing head offices which instructed and supervised a small number of branch corporations in China's major cities, the corporations still reflected the Soviet model which had helped inspire them when they were first created soon after the People's Republic of China was founded in 1949.

Beginning in 1978, however, this simple arrangement has been greatly changed. Autonomy has been given to large cities such as Tianjin, Shanghai, and Beijing and to some provinces as well, particularly Guangdong and Fujian. The former branches of the trade corporations now are much more closely directed by local authorities than by the Beijing head offices. In addition, many new entities have been created, often the extensions of Chinese ministries responsible for various sectors of the economy. For example, almost every ministry of machine-building now has its own foreign trade corporation, as does the Ministry of Metallurgical Industry, the Chinese Academy of Sciences and the Science and Technology Commission. There are many others. At the top, responsibility for overall direction of Chinese foreign trade policy passed in 1979 to the Export-Import Control Commission. A close relative of the Commission, created at the same time, is the Foreign Investment Control Commission, operating out of the same offices with the same personnel, and which is in charge of formulating policy toward equity joint ventures with foreigners, selecting suitable projects eligible for such investment, and approving joint ventures after they have been negotiated. In addition, a host of "international trust and investment" corporations charged with seeking and brokering foreign investment have also been created all over the country.

Perhaps most remarkable, a number of special economic zones have been created, at the moment principally in the southern provinces of Guangdong and Fujian, to encourage export-oriented projects with tax and other incentives. Most of the investment in these zones has come from Overseas Chinese businessmen in Hong Kong, Macao and elsewhere in Southeast Asia. A Chinese source recently reported that by June 1981, contracts had been signed for foreign investment of \$400 million in the Special Economic Zone of Shenzhen, just across the border between Hong Kong and Guangdong Province, and the largest of the three zones in that province. To the visitor to Shenzhen, the bustle of change is striking, as a sleepy little market town is transformed into a commercial center. The zones represent an experiment which is being closely watched in Beijing and all along the China coast, possibly with an eye to creating other special areas dedicated to foreign trade, although not necessarily under the same concessionary terms.

New transactions

Coupled with the proliferation of organizations with which it is possible to negotiate is a striking new diversity in the types of transactions which are possible. Until very recently the China trade was usually a simple matter of cash purchases or sales of products and, in only relatively few cases of Chinese whole-plant purchases, of technology. In recent years, however, foreign equity investment has become possible; by the end of 1981 approximately 30 joint ventures had been approved. Although most of that capital came from Chinese business in Hong Kong and elsewhere in southeast Asia some also came from other countries, including one venture which is owned 100 percent by a U.S. company with a Thai partner. None yet involve large heavy industry projects, although foreign cooperation in coal mine development, which has been actively discussed for several years, may soon be given concrete form in a joint venture. Countertrade transactions have multiplied, in which the foreign side supplies equipment, technology and production know-how in return for finished products, and many processing contracts have been signed under which foreigners supply raw or semi-finished materials which are processed and then re-exported.

Of particular interest to U.S. companies should be the growing number of technology licenses. Formerly, the China National Technical Import Corporation ("Techimport") exercised exclusive responsibility for such transactions, which were principally negotiated in the context of whole-plant purchases, such as for fertilizer plants. Lately, however, reflecting the organizational changes noted above, not only Techimport but newly created organizations have been negotiating technology licenses, particularly in the areas of machine-building, electronics, and instrumentation. For instance, the China Corporation of Shipbuilding Industry (an enterprise of the Sixth Ministry of Shipbuilding, which runs China's shipbuilding) announced in September 1981, that it had concluded 15 agreements since 1978 for the import of technology for use in the manufacture of such items as diesel engines, gear boxes, cargo handling equipment and other marine-related products. A number of U.S. companies have signed licensing agreements in recent years.

A few words are in order on current Chinese practice in technology licensing: Chinese licensees prove to be extremely and understandably interested in obtaining as much technology as possible and the broadest guarantees that the licensed technology will achieve the desired results. The Chinese side wants the licensor to commit himself to assist the licensee to correct any defects which appear when prototypes incorporating licensed technology are tested. As a result of these twin Chinese concerns, licensors are apt to regard licensing in China as potentially involving them in expending large amounts of time in transferring the licensed technology and thereafter working with the licensee to make sure that prototypes perform satisfactorily.

Licensors have been concerned about protecting their technology and know-how. At this time China lacks a patent system, and although a draft patent law has been prepared its promulgation has been delayed, apparently at least in part because of the debate within China between some ministries which want to import technology under license and others which have been copying foreign equipment without licenses and wish to continue doing so. Until a patent law is promulgated, licensors can protect themselves only by contract clauses forbidding disclosure of the licensed technology to third parties.

Other problems which licensors frequently encounter include the Chinese desire to export products manufactured using the licensed technology. Licensors are often reluctant to put competitors into business, but the Chinese may respond that only through exports can sufficient foreign exchange be generated to pay the licensors' royalties. Royalties may be an issue on which the parties' points of view may be very different: The Chinese may prefer to pay licensors in products, or in royalties which do not begin to run until a considerable period of time after the agreement was signed; licensors may not want the products and would prefer larger royalties earlier in the life of the agreement. These and other issues probably require more time for negotiations currently than they will in the future, as the Chinese agencies concerned acquire more experience.

New choices and problems

One of the consequences for the foreigners' investing possibility in China is that their range of choices has widened dramatically. Not only is a variety of transactions now possible that was unthinkable 4 or 5 years ago, but the number

of possible partners has positively exploded. Is the foreigner better off trying a joint venture, a technology license, a countertrade transaction, or some combination? Should he go directly to Beijing and deal with a trade corporation or a corporation representing a ministry? Should he go to a city or province without bothering with Beijing? Should he go directly to his opposite number or should he include in the negotiations one of the new trust and investment corporations, either China International Trust and Investment Corporation (CITIC) which purports to act nation-wide or a local variant which acts on behalf of the province or municipal authority which created it, as in Tianjin or Shanghai? Regardless of which avenue he pursues and which partner he chooses, which higher-level authority must approve any contract which might result?

These are not abstract problems. For example, U.S. oil companies which signed agreements with the Ministry of Petroleum to conduct seismic surveys for offshore petroleum signed their agreements with that Ministry, only to find that the Ministry of Geology in some offshore areas has insisted on conducting its own seismic work. U.S. importers who have signed contracts with one entity which gave them the rights to exclusive distributorships of certain products in the United States have discovered that other Chinese entities have been offering identical products to other U.S. importers. Companies which intend to negotiate on projects in the Special Economic Zones have been told in Beijing that projects over a certain value must be approved in Beijing, while Special Economic Zone authorities have said that no such approvals are necessary.

Moreover, policies have not been consistent. For example, when the policy of encouraging foreign equity joint ventures was first announced in 1979 one of the major attractions was access to the domestic market which such projects would have. Then, in 1980 and 1981 foreigners attempting to negotiate agreements were told that the projects had to be self-sufficient in terms of foreign exchange and that therefore they had to be principally export-oriented. By the end of 1981 policy had apparently relaxed again.

In the face of the extensive changes summarized above, many foreign businessmen have grown frustrated. The most sophisticated of them knew even before they came to China that negotiations would be long and difficult, but the proliferation of partners (and the frequently resulting need to travel to many places and spend much time engaged in purely exploratory discussions), the overlapping of jurisdiction, and the blurring of lines of authority have multiplied confusion faster than opportunities. It is no wonder that a Vice-Chairman of the Export-Import Commission and the Foreign Investment Control Commission was quoted in an interview in the *Far Eastern Economic Review* in December, 1981, as follows on the policy of decentralization of decision-making:

"I have to admit, we are quite inexperienced in this matter. How can we manage to grant greater autonomy to local levels but not [let the situation] run into disorder and chaos?"

LEGAL DEVELOPMENTS

A recent and continuing development in the China trade is the promulgation of new laws and regulations intended to create a formal framework of rules where few existed before. Formerly, the China trade was conducted in a legal vacuum. No legal rules, Chinese or otherwise, were referred to either in contract negotiations or in contracts themselves. This posed no great difficulty, given the relative simplicity of the transactions. Even dispute resolution was unmentioned in Chinese contracts other than purchases of major capital goods. And in fact, even if third-country arbitration clauses were included in contracts, negotiation looking toward compromise was the strongly preferred Chinese response to the occurrence of a serious contract dispute.

The last 4 years have seen the appearance of a number of new laws. The new Chinese policy of hospitality to foreign equity joint ventures was signaled by promulgation of a statute on "joint ventures using foreign investment," issued in 1979, and supplemented by several sets of regulations in 1980, notably one on labor and wages in joint ventures. Statutes on taxation of the Chinese-source income and of foreign equity joint venture partners and of individual foreigners employed in China were also enacted. These statutes have been supplemented by regulations. Completing the task of comprehensively meeting the need to define the rules on taxation of income of foreigners is a statute promulgated in late 1981, establishing the rates of tax on foreign economic activity in China other than that of joint venture partners. Regulations supplementing that law have already been drafted, and are due to be promulgated shortly.

In addition to the nation-wide legislation mentioned above are rules which have been adopted to define the regimes applicable to investments in the Special Economic Zones established in Guangdong Province in areas close to Macao and to Hong Kong, and in Fujian Province. These regulations, setting a tax rate lower than that otherwise applicable in China, as well as other incentives, have begun to provide a framework to which foreign investors may refer in order to ascertain their treatment if they invest in the export-oriented projects favored in the Special Zones.

Other noteworthy new laws include regulations on the activities of foreign oil companies, issued in February, 1982, and a law on economic contracts which, although basically intended to govern relationships among domestic Chinese enterprises will also apply to some extent to transactions between foreign joint ventures in China and domestic Chinese enterprises. A code of civil procedure has been adopted for early promulgation. Other laws are being prepared on trademarks, some accounting matters such as depreciation of fixed assets, and foreign trade contracts. Regulations implementing the new general law on foreign equity joint ventures are also drafted. Both the recent activity and the plans of China's drafters of economic legislation express a determination to establish stable institutions for trade and foreign investment.

In the limited space provided here, it is impossible to analyze the laws which have been adopted. More helpful perhaps may be to set forth here some generalizations about patterns and the likely course of development of Chinese-lawmaking in areas which concern potential traders and investors:

First it should be stressed that laws, when initially promulgated, although they may be preceded by considerable study (including reference to foreign practice), also reflect hesitancy to fix too firmly the conditions of a rapidly evolving situation. Chinese laws on particularly significant subjects such as the basic conditions applicable to foreign equity investment, or the rate of tax which shall be paid by foreign taxpayers, are typically brief and very general formulations of rules. The foreigner who needs guidance must await further regulations. In the meantime, other forms of interpretation must be relied on, including the views of officials in private conversations on the impact of a statute or regulation on some contemplated activity. All of the laws mentioned above are so new that either regulations have not appeared or else are so recent that practice is not settled. The situation is so new and evolutionary that law will replace uncertainty only very slowly.

Next, it is important to inquire into the aims of the Chinese leadership which is responsible for the rapid outpouring of rules which affect foreign economic activity. In some ways, the new emphasis on law is revolutionary. China before the PRC was established lacked a legal tradition in the Western sense, and was not accustomed to regulating economic activity by law. Since 1949, although many laws and regulations have been promulgated, policies as they were implemented by the Chinese Communist Party have been more important than either law or the government bureaucracy. The new attempt to systematize economic activity by law raises some important issues.

The relationship between law and policy, often blurred in China during the last 30-odd years, will have to be redefined. In the past, changes in policy have left legal provisions, even newly drafted ones, inapplicable. Foreign investors and traders require, and hope for, greater stability. The role of the Party, once decisive in day-to-day matters in executing policies, has now also been put into question. To what extent will the legal institutions and legal rules be autonomous of Party control and influence?

Also, although much of the discussion in Chinese journals and the media emphasizes the role of law as reinforcing economic discipline, to what extent will law be viewed as creating rights? China has little tradition of encouraging individuals or groups to base claims on the law of the state, and the legal history of the PRC does not encourage observers to think that laws may soon be an effective basis for the assertion of claims. Although increasing the stability of expectations is an aim of the new law-making, Chinese officials economic and otherwise have in the past preferred to iron out compromises of difficulties, preferably in a context of personal relationships. Such habits are going to be difficult to change.

At the same time, it may be that the Chinese expect too much of their legal institutions at this early time in their rebuilding. Of particular interest in this regard are provisions in several Chinese laws, notably in one on labor matters

in equity joint ventures and one in the foreign enterprise income tax law, which each provide for the possibility that disputes may be taken to local Peoples' Courts. The courts have only intermittently and for brief intervals been allowed to develop any professionalism. They are still undermanned, and many judicial personnel are untrained. The same is true of the small number of lawyer offices, only recently reestablished after more than 10 years in limbo. Recently, to augment the small number of judges and staff at the courts, former Chinese army officers have been transferred to the courts. It would seem that the courts will require considerable time before they will be able to play a useful role in settling disputes which involve foreigners.

In light of the developments and uncertainties summarized immediately above, the U.S. businessman is best advised to look attentively to the new laws as they appear and are interpreted, while at the same time not expecting the fluidity of the present situation to disappear soon. The reach of legal provisions over his transactions may not be recognized in quite the same manner by his Chinese counterpart, and if differences arise the Chinese side may still likely prefer negotiations and compromise to a decision brought about by a court or a third-party arbitration, even if access to them is formally possible. Law has not yet been effectively distinguished from policy, but the direction taken by legal growth in recent years should encourage foreigners interested in trade and investment in China.

NEGOTIATIONS

Despite the novelty of the organizational changes and new laws discussed above, negotiations with Chinese trade officials do exhibit patterns and consistencies, at least in this author's experience during the last 10 years. The pages which follow immediately below generalize about negotiating on trade and investment transactions in China.

Necessary preliminaries to negotiations

To a surprisingly great extent, even 10 years after United States-China trade resumed, many U.S. businessmen still assume that all or most of the influences on the speed, content and agenda of their negotiations in China must be determined by the Chinese without the foreigners having much to say in the matters. One American businessman, for instance, has recently stated "... the seller must adjust himself to the procedures of the Chinese, who establish the agenda, change the topics and pace the negotiations; the seller must stay in China as long as the Chinese consider it adequate." These views, as broadly stated without qualifications as they are, counsel a passivity in negotiations which should not be encouraged. To be sure, both sides will be the victims of the slowness of the Chinese bureaucracy. However, much of this author's experience suggests that, to the contrary, the foreign side can have much to say about the agenda and pace of negotiations.

These, however, will usually depend on the extent to which careful preparation for the negotiations has been conducted, including lengthy discussions in Beijing and sufficient exchanges of information and probes of answers to questions to clarify both parties' expectations about the negotiations. It is essential, for instance, for foreigners to probe as deeply as they can into the authority of the organization with which they propose to negotiate, into alternative negotiating partners, and, if possible, the likely consequences of negotiating with one rather than the other. Rivalry among the foreign trade corporations and the organizations newly involved in foreign trade is considerable, and the concerns on the Chinese side to keep the foreigners away from potential rivals may often be not very subtly expressed.

If the foreign representative preparing for negotiations has received answers on the above-mentioned subject which are to his satisfaction, he must then probe further: In these days of leadership emphasis on increasing foreign exchange earnings, the expectations and hopes of the Chinese side may often be exaggerated. Furthermore, because of the verticality of the Chinese bureaucracy, the organization with which negotiations are to be begun may not have contacted other organizations whose permissions, concurrence, or cooperation in the execution of the eventual transaction may be necessary. For instance, after an agreement was signed on a planned World Trade Center in Beijing by Beijing municipal authorities and the American side, the factory whose land was chosen as the site for the new center refused to agree to let its land be taken for the purpose, one of the reasons for the transaction's collapse.

Also, the Chinese side may be most optimistic about its ability to work out a transaction which will be attractive to the foreign side, without having contacted authorities in a position to influence the shape and content of the proposed contract. A factory, for instance, approached in a joint venture negotiation may be willing to agree that the level of welfare benefits paid to workers by the joint venture could be at a level lower than that which the Foreign Investment Control Commission believes to be appropriate; in the final analysis, however, the views of the Foreign Investment Control Commission are decisive.

These, at any rate, are the type of questions which should be investigated in considerable depth and detail even before a formal negotiation begins. If they are, they may prevent wasted trips, and should make more productive any negotiations which do take place.

Technical discussions

Even more crucial to the success of any formal negotiation is adequate preparation by both sides on technical aspects of the proposed transaction. When the foreign trade corporations monopolized China's foreign trade, their representatives always preferred to discuss technical matters first, only then to be followed by commercial discussions. They and most other organizations insist on the same order of discussion, and as a result the foreign side must be prepared to engage in lengthy technical discussions as a preliminary not only to formal contract negotiations, but sometimes also before any general discussions of the commercial principles that might govern the proposed transaction.

In these matters Chinese preference is crucial in shaping the negotiations, and the foreign side is best advised not to reverse the order of discussion of commercial and technical subjects. The foreign side should first be prepared to go through all the technical aspects of the proposal, ascertain whether there is a basis for agreement on the technical aspects, and then go on to discuss commercial aspects of the transaction. Because of the strong emphasis on technical matters, it is often not even necessary to bring a draft contract to the first negotiation; an outline of such a contract is probably sufficient.

The technical discussions are usually highly detailed. The Chinese try to go as deeply as possible into the proposal and, often, into much of the design and conceptual thinking that lies behind a proposal. Sometimes, because basic concepts may differ, and also because educational levels, particularly among younger technical specialists, are uneven, many questions may be raised because the Chinese side has failed to understand some aspects of the foreign proposal. The foreign side must be prepared to discuss all the details patiently, and also to use the occasion as an opportunity to demonstrate its technical competence.

In this connection, the Chinese side may often probe so deeply as to enter into proprietary areas. Here, the foreign side is best advised to refuse to discuss those areas which it does not wish to discuss. This can be done in a polite fashion without offending the other side. In some instances, the Chinese have been willing to sign confidentiality agreements.

The process of technical explanations and discussions can be lengthy, and can require repeated visits by competent personnel to China, sometimes to travel to a proposed site. The length of negotiations, because of the detail into which they delve, creates one of the greatest opportunity costs of doing business in China. But it is only by expending that effort that the two sides can establish whether they have a basis on which to negotiate.

Lengthy technical discussions also perform a useful additional function because they allow each side to assess the other's technical competence. In this author's experience there is no better way for a foreign seller to impress a Chinese buyer than by sending able technical specialists as representatives. This, too, of course adds to the opportunity cost, but it should also benefit the seller's reputation with the foreign organization with which he negotiated.

Commercial negotiations

The negotiators.—So far as the commercial negotiations themselves are concerned, we may begin with the negotiators themselves. Many at the Foreign Trade Ministry's foreign trade corporations have a great deal of experience negotiating with foreigners. Many at the new organizations, only recently created and given autonomy to engage in foreign trade transactions, are considerably less experienced. However, the long experience of a foreign trade negotiator may cause him or her to believe that the form contracts which they have been accustomed to using over the years must be the basis for the contract to be signed by the par-

ties, whereas the newness at their trade of some of the other foreign trade negotiators may be reflected in considerable flexibility and open-mindedness, albeit often tinged with inexperience. The mixture of factors and the personal chemistry which may exist between Chinese and foreign negotiators is impossible to predict. It should be pointed out, perhaps contrary to the expectations of many, that considerable personal discretion is given to negotiators, albeit within certain boundaries, so that in matters of language and style, often of great concern to foreign lawyers from the West, the degree of receptivity shown to their concerns may vary extensively.

The contract.—It is commonly and accurately said that Chinese negotiators have an aversion to complicated contracts. In a number of instances in which this author has either had personal experience or which he has been reliably informed, after being given a lengthy draft contract the Chinese side has refused to read it and asked the foreign side to redraft it to make it more easy to understand. Sometimes, this has gone on for several rounds until the foreign side digs in its heels and refuses to shrink the contract any further. The Chinese have a very strong resistance to legalistic language and to the very lengthy form contracts which many U.S. corporations bring to China simply because they are so accustomed to using them in so many other jurisdictions. It turns out, in this author's experience, that the lengthy contracts which are so often used as a matter of habit can be easily shortened without causing serious prejudice to the client's interests. Often, differences of opinion over the length and contents of a contract are provoked by totally different points of view of both sides: The Chinese side usually prefers to spell out some of the implications of successful implementation of a contract, whereas the U.S. side often feels compelled to explore all of the details if a default occurs.

So, for instance, the Chinese prefer a very general *force majeure* clause, which is addressed to causes beyond the control of the parties which interfere with their ability to carry out their obligation under the contract and which, because they are beyond the parties' control, excuse them temporarily or permanently from performing. Many American lawyers prefer to spell out all the circumstances that may amount to excusable *force majeure*, adding also blanket clauses that would cover such esoteric difficulties as squirrels shorting out power lines or plagues of locusts.

On dispute settlement, too, the parties' views may differ greatly. The U.S. side usually prefers to specify the method that will be used to resolve a dispute which the two parties cannot themselves resolve, either in a judicial or arbitral forum, and to state the law that will be applied. The Chinese will argue for emphasis on settling disputes through "friendly negotiations" or, if those should fail, through arbitration. They would prefer that arbitration be carried out, if at all, in China, although when pressed in negotiations on large contracts they have been willing to agree to arbitration conducted by the Stockholm Chamber of Commerce. Other third countries have also been agreed to, although much less frequently.

However, the Chinese are only rarely willing to agree in advance on the law which will govern interpretation of a contract. Unfortunately, in the absence of such a clause an agreement to third-country arbitration provides less certainty than it might. The Stockholm Chamber of Commerce, for instance, to whose arbitration procedure the Chinese have been willing to agree to resort, will, in the absence of the parties' prior agreement on the applicable law, apply the law of the place most closely connected with the transaction, which may well be China. Since Chinese contract law is most difficult to ascertain, the choice of Stockholm as a place to arbitrate will not necessarily provide the parties a predictable mode of resolving their dispute.

However, it must be added that past Chinese preferences in these matters is not likely to change soon: Regardless of whether the contract contains an arbitration clause, and regardless of where such a clause may require arbitration to be held, the Chinese side will do all it can to avoid arbitration or any other type of third-party dispute resolutions by negotiating a compromise solution to the dispute in question. Chinese trade and legal specialists have continued to emphasize their preference for compromise and conciliation of disputes.

For all the differences in attitudes toward legal aspects of contracts that have existed in the past, some signs of change are evident. As transactions become more complex and varied, the Chinese recognize the usefulness of a contract in stabilizing the expectations of both sides. Discussions in economic journals have begun to emphasize the role of contracts in international transactions, parallel-

ing a similar development domestically. Although the number of Chinese who have been sent to study legal aspects of international trade is small, it is growing. The time is coming when this author, as a lawyer specializing in the China trade, will find sitting across a table in Beijing a Chinese negotiator who has studied at an American law school.

CONCLUDING NOTE

If any theme emerges to underlie the three elements discussed here, it is emphasis on slow evolution—in organization, in complexity of transactions, and in attitudes toward laws. This means that the U.S. businessman must be prepared to encounter uncertainty, and to meet it with patience, careful preparation, technical competence and resourcefulness. The history of the past 10 years of United States-China trade suggests that many U.S. companies have at various times become overly excited about prospects in China, only to be soon and sometimes expensively disappointed. But the opportunities have always been only selective, and patience has always been indispensable. It might be noted in passing, for instance, that U.S. imports from China of manufactured goods have continued to grow, reflecting the patient hard work of U.S. importers. Statistics tell the story here, but not completely. The hard work that is necessary to find and match a Chinese source of manufactured products with its American market is very great.

The China trade will probably grow more complex, but it will not necessarily offer reassuring internal consistencies. Striking to any student of China has been swinging in Chinese economic policy which seem bound to be reflected in trade. Decentralization will continue to be generally favored in the near future (partly because it will be so difficult to undo), and the practical result will be that Chinese provinces and cities will continue to seek foreign capital and technology, requiring foreigners to expand considerable time and energy in discussions with alternative Chinese partners. If the center seeks to reassert its control, some transactions may be modified or undone. Such fluctuations are not likely to disappear, and will add to the frustrations of the China trade.

Much of this discussion has emphasized problems, not because of pessimism but experience. The U.S. business community seems to need counsels of realism and patience. These need not conflict with enthusiasm, but must be harnessed to it.

Mr. SUTTER. Thank you very much.

Our next speaker will be David S. "Scotty" Holland, from the Pennzoil Co. He was educated at the University of Texas, and has had a lengthy career as a geologist and as a manager with the Pennzoil Co. In 1977, he was appointed vice president, oil and gas exploration, Pennzoil Co., and in May 1979 he was appointed to his present responsibility of senior vice president, exploration, Pennzoil Exploration and Production Co.

Mr. Holland, please.

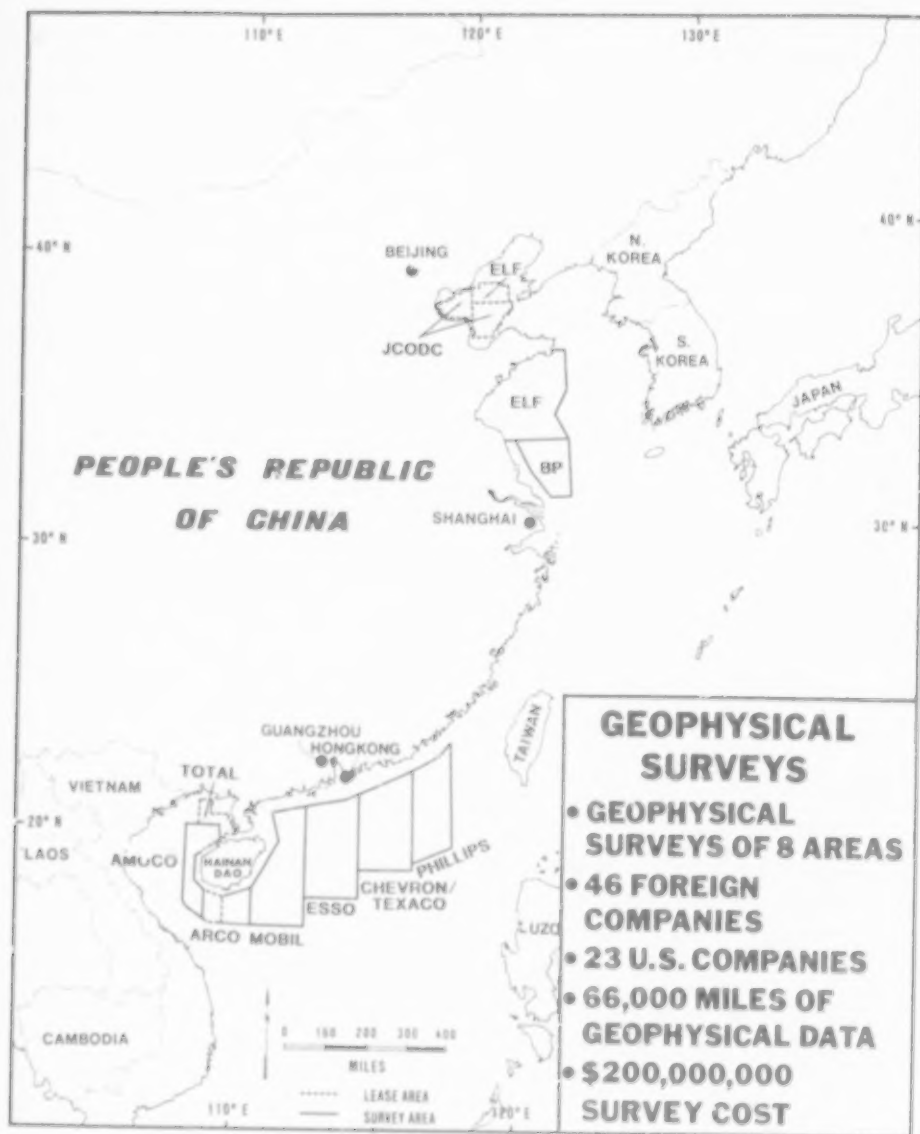
STATEMENT OF DAVID S. HOLLAND, SENIOR VICE PRESIDENT OF EXPLORATION, PENNZOIL EXPLORATION AND PRODUCTION CO., AND PRESIDENT OF PENNZOIL FAR EAST LTD., HOUSTON, TEX.

Mr. HOLLAND. Thank you, Bob. Let me begin by using slides.

The People's Republic of China has a significant potential for oil exploration and production in its offshore waters and an immediate need for technological expertise and investment capital to develop that potential.

Pennzoil, along with 45 other international oil companies, was invited by the PRC to conduct geophysical surveys in the offshore areas in the South China and Yellow Seas. These studies have been completed.

[Slide.]



OFFSHORE CHINA

78	79	80	81	82	83	84	85	86	87	88	89	90	91	92	93	94	95	96	97	98	99	00	01	02
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INITIAL DISCUSSIONS

GEOPHYSICAL SURVEYS

CHINESE LEGISLATION & SURVEY REVIEW

BIDDING, NEGOTIATIONS & CONTRACT SIGNING

EXPLORATION (5 YRS.)

DEVELOPMENT (6-9 YRS. PER FIELD)

PRODUCTION (15 YRS. PER FIELD)

On the slide, you can see to the northern areas that have been awarded the two concessions to the south. There you see where Total, just north of Hainan Island, has its concession. Then you can see the Arco's concession just south of Hainan Island.

An advantage for the American public in this expanded trade with China is the addition of another major source of oil. Opportunities for U.S. companies offering oilfield services and supplies and related technology should expand, however, it should be remembered that China will insist on using as much of its own equipment as possible.

Each company submitted reports evaluating the hydrocarbon potential of the survey area in which they participated. In addition to evaluating these reports, the Chinese wrote tax laws, model contracts, and petroleum legislation before issuing invitations to bid on the offshore areas. Bidding, negotiations, contract awards, exploration, development, and production are the next steps.

[Slide.]

BIDDING PROCESS

- INVITATION TO BID
- INFORMATION PACKAGE
 - INSTRUCTIONS
 - LOCATION MAP
 - PARTICIPANTS
- APPLICATION TO BID
- BID PACKAGE
 - CERTIFICATION, REGULATIONS, MODEL CONTRACT,
BID PROPOSAL, TAX LAWS, RELATED DOCUMENTS
- BIDS
- CHINESE REVIEW, NEGOTIATIONS
- CONTRACT AREA AWARD

OFFSHORE CHINA

82 83 84 85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02

- I INVITATIONS TO BID
- I BIDDING PACKAGE & DOCUMENT DISTRIBUTION
- BID PREPARATION
- CHINESE BID REVIEW
- NEGOTIATIONS, CONTRACT SIGNING, AWARDS
- DETAILED GEOPHYSICAL SURVEYS
- EXPLORATORY DRILLING
- PRODUCTION PLATFORMS
- DEVELOPMENT DRILLING
- PRODUCTION EQUIPMENT
- PIPELINE / SPM

PRODUCTION

Mr. HOLLAND. The Chinese sent invitations to bid to qualified companies in mid-February. Those companies responding to the invitation received a package containing instructions to the bidders, a location map of the areas for first-round bidding, geographic coordinates of the areas, and a list of the participants in the survey areas. After companies make their application to bid, they will receive another package

containing a certification qualifying them for bidding, petroleum regulations, a bid proposal form, relevant tax laws, and other related documents. Bids must then be submitted no later than 100 days after the application period ends.

After the Chinese review the bids and negotiate the final terms, contracts will be awarded to individual companies or groups of companies. After awards are made, the next step will be detailed geophysical surveys and exploratory drilling.

Almost two-thirds of the 277 tracts being offered in the 22 contract areas of the Pearl River Mouth Basin region will be in water depths greater than 600 feet. If all of these areas are to be tested prior to additional rounds of bidding, semi-submersible rigs and drill ships will dominate the exploratory drilling.

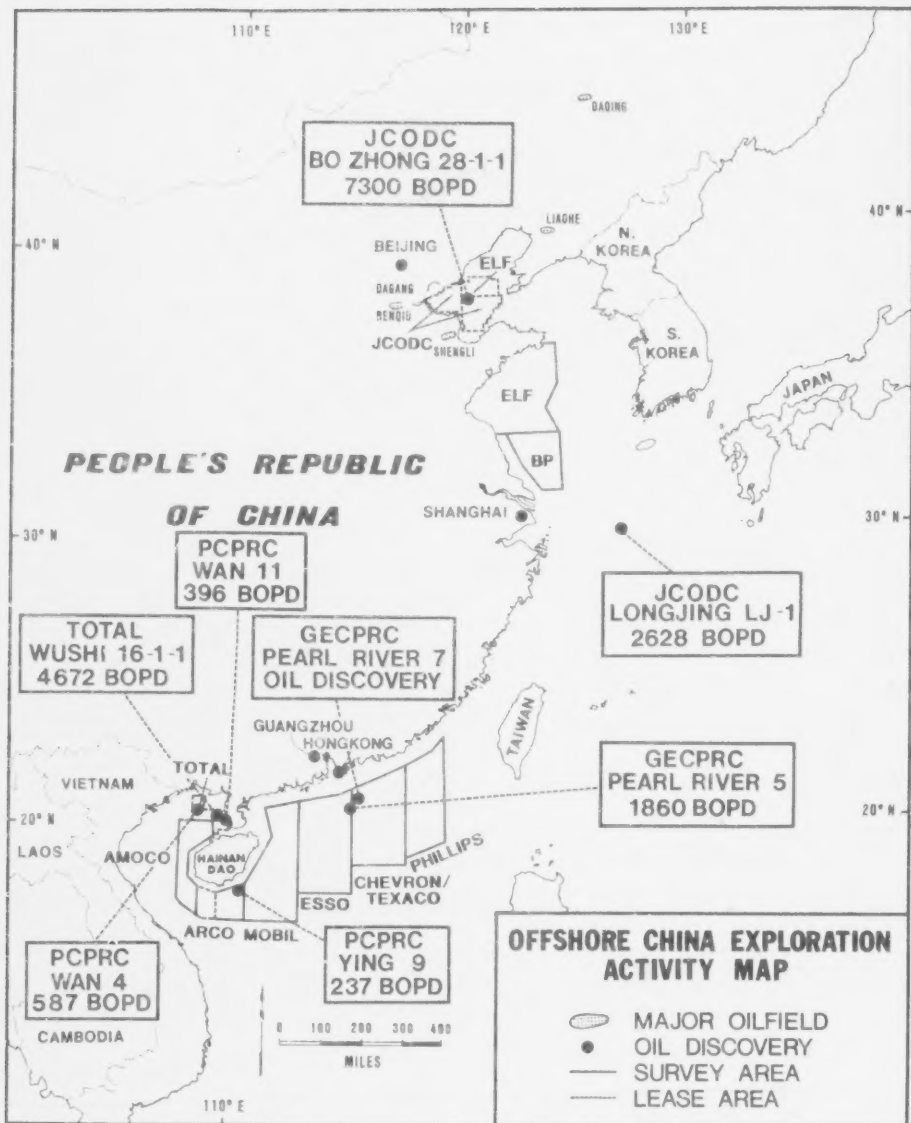
Once commercial hydrocarbons are established and a development plan is submitted and approved, the development phase will commence. Platforms then will be designed, constructed, positioned, and development wells drilled. Production should commence in approximately 5 to 8 years after the awarding of the contracts.

Second and third rounds of bidding within the four survey areas of the Pearl River area are anticipated after production has commenced and the infrastructure for offshore operations is functional.

[Slide.]

FOREIGN ENTERPRISE TAX LAW

- **48.75 PERCENT TAX ON MOST U.S. COMPANIES**
- **CREDIT TO U.S. FEDERAL INCOME TAX NEEDED FOR U.S. COMPANIES TO REMAIN COMPETITIVE WITH EUROPEAN AND JAPANESE COMPANIES**
- **STILL AWAITING ISSUANCE OF INTERPRETATIVE REGULATION BY PRC**
- **TREASURY DEPARTMENT (IRS) MUST REVIEW REGULATIONS FOR CREDITABILITY**
- **U.S. AND CHINA SHOULD CONCLUDE A TAX TREATY WHICH WILL RESOLVE ISSUES**



Mr. HOLLAND. A delay in U.S. participation in offshore China oil has been the passing by the PRC of a petroleum law, a foreign enterprise tax law, and model contracts.

The foreign enterprise tax law was enacted by the PRC, effective January 1982, that would levy a 48.75 percent tax on most U.S. companies. This tax, in turn, would be credited against a company's U.S. taxes, subject, of course, to the approval of the IRS. However, at this time the Chinese have not enacted the rules and regulations that accompany this tax law, and an income tax treaty is needed between the United States and China which would resolve the creditability issue.

Contract terms are expected to be based on similar contracts and

agreements made by the Chinese and by other countries with foreign oil companies. The Chinese have said the international oil companies must pay all of the initial exploration costs and approximately half the developmental costs with recoupment from future production.

Phase III, or the production phase, has been suggested as lasting for between 15 and 20 years. From this production—that is, the money from the production, operating expenses, Chinese royalty—and we estimate 15-plus percent—exploration cost recoupment and the 48.75 percent tax will be paid with the remaining production divided on an agreed-upon percentage between the companies and the Chinese. That will probably be one of the big factors. After all expenses, taxes, and fees, foreign oil companies expect to receive at least 20 percent of the value of each barrel produced during the production phase. That may be optimistic, but that is an expectation.

The Chinese plan to provide as much of the support for the exploration and development of their offshore property as possible and will give preference to equipment made in the PRC.

Major supplies, construction, computers, and administrative facilities are being planned for Zhanjiang, Shekou, south of Hong Kong, Shantou, Senya, and on Hainan Island.

The international petroleum companies have assessed that the three basic ingredients for the accumulation of hydrocarbons—that is, the source, reservoir, and traps—are present in the China offshore. The amount of accumulation is speculative, and only time and a drill bit will complete the story.

Wells drilled in the Beibu Wan area, the Pearl River Mouth Basin, the East China Sea, and the Bohai Gulf have had favorable results and high success ratio. However, published reports state that a recent production tests in the South China Sea have ranged from several hundred to more than 4,500 barrels of oil per day. These discovery rates and production tests encourage and justify the oil industry's efforts.

China's petroleum industry could well provide the biggest source of commercial trade between the United States and the PRC by the end of the decade. The development of China's offshore oil is one of that country's most important economic priorities.

Oil is needed to fulfill China's four modernizations: Agriculture, industry, national defense, science and technology. Oil also is needed as a primary source for foreign exchange for China. Consequently, the PRC now seeks foreign cooperation in joint ventures for its extensive offshore industry.

However, in order to justify the estimated 20 plus or minus billions of dollars it may take to explore for and to produce the potential reserves found, very large accumulations and wells with high flow rates are necessary.

These high costs probably mean the return on investment will not begin for 6 to 8 years. In order for this investment to pay off, the contract terms will have to be competitive with other terms on a worldwide basis. Subsequent contracts will need to allow potential rewards commensurate with the risks taken. The Chinese at this point recognize these risks and, I think, are structuring their contracts accordingly.

As a result of U.S. involvement in offshore China oil development, America could have access to a new and stable source of oil. This source also could help alleviate the possible shortages in Japan and other countries in the Far East, in addition to replacing China's declining production.

After that review of facts, I would like to jump now to some of the criteria for success.

[Slide.]

CRITERIA FOR SUCCESS

- **SOUND WORK PROGRAM, QUICKLY IMPLEMENTED, COMPETITIVE**
- **PRIOR CONTRIBUTIONS TO SURVEY PROGRAM**
- **STATE-OF-THE-ART TECHNOLOGY**
- **STRONG TECHNICAL TEAM**
- **EXPERIENCED MANAGEMENT**
- **SIGNIFICANT OFFSHORE EXPERTISE AND EXPERIENCE**
- **FINANCIAL CAPABILITY**
- **"OLD FRIENDS"**
- **USE OF CHINESE-SPEAKING INDIVIDUALS**
- **IDENTIFICATION OF KEY ORGANIZATIONS AND INDIVIDUALS**
- **PATIENCE**

CONCLUSION

- **RESOURCE OPPORTUNITY**
- **HIGH RISK — HIGH POTENTIAL**
- **TECHNOLOGY AND FINANCIAL ASSISTANCE**
- **COMPETITIVE WORLDWIDE**
- **TAX TREATY U.S. — CHINA**

Mr. HOLLAND. Successful bidding will depend on a company's proposed work program, technical expertise, and financial capabilities. Of course, a successful bid will have to be competitive with the bids of other companies making those bids.

The Chinese have expressed interest in knowing management and the level of experience and technical capabilities of their scientists.

A company's track record is important. Once a company has established itself as having a sound organization, with significant offshore

expertise and experience, future discussions and business dealings with the Chinese are much easier.

The financial requirements necessary for the offshore petroleum commitment are another major consideration. A company must be financially capable of fulfilling all of its commitments to the Chinese and may be asked to assist the Chinese in locating financing.

The Chinese prefer to work with old friends and look for overall credibility, honesty, sincerity, candidness, and openness in their dealing with the foreign companies.

A successful negotiation team also will need to display a great deal of patience and perseverance.

A company should have either an employee or a consultant who can speak Chinese in order to speed negotiations and communications with the Chinese.

In Pennzoil's experience, Chinese-Americans with a technical background offer certain additional advantages.

To deal effectively with the Chinese, a company must correctly identify the appropriate organizations and individuals responsible for its particular field of interest. Many of the Chinese organizations overlap with two or more sharing responsibilities.

Finally, the Chinese expect legal commitments that are based on equality and mutual benefit as their main concern is to succeed for their people.

In conclusion, the development of the PRC's offshore energy resources offers a significant opportunity for U.S. petroleum companies and other related American concerns. The risks are high, but the geophysical and geological data indicate that the region has considerable hydrocarbon potential.

China realizes that investment of high technology and financial assistance are needed to develop their offshore oil fields. If the U.S. companies do not aggressively partake of this opportunity, then other countries will gain the advantage in future trade through their representative companies.

With the passage of China's new foreign enterprise tax laws and petroleum regulations, a major legislative inhibitor which has kept U.S. companies from direct involvement in the PRC petroleum industry has been eliminated. The United States and China now need to negotiate and conclude an income tax treaty which would resolve any remaining tax questions.

If the offshore China contract terms are competitive with terms of contracts with other countries, the next step for the U.S. companies will be bidding, negotiating, contract awards, drilling of exploration and development wells, and finally the production of oil.

Thank you very much.

[Mr. Holland's prepared statement follows:]

PREPARED STATEMENT OF DAVID S. HOLLAND

U.S. PETROLEUM INDUSTRY DEVELOPMENTS WITH CHINA

Introduction

The People's Republic of China has a significant potential for oil exploration and production in its offshore waters and an immediate need for technological expertise and investment capital to help develop that potential.

Pennzoil, along with 45 other international oil companies, was invited by the PRC to conduct geophysical surveys in offshore areas in the South China and Yellow seas. These studies have been conducted and reports have been returned to the Chinese.

The 23 U.S. companies have fared well in the surveys and should become major partners with the Chinese when contracts are awarded, probably later this year.

The next step in China's offshore energy development has begun with the receipt of invitations to energy companies to bid for the drilling rights on approximately a third of the area included in the geophysical studies. At stake in this bidding process is an oil potential that could rival some of the world's major producing regions. The potential is large, but the risks also are large.

A possible advantage for the American public in this expanded trade with China is the addition of another major source of oil. Also, opportunities for U.S. companies offering oilfield services and supplies and related technology should expand somewhat as these offshore areas are explored.

China will insist on using as much of its own capability as possible in offshore exploration, but the PRC has shown a strong desire to incorporate the latest, most advanced technology available.

Initial activities: 1978-81.—In 1978, at the invitation of the Chinese, Pennzoil sent a delegation to the PRC to discuss possible exploration in China's offshore waters. The delegation, consisting of 15 individuals, was headed by J. Hugh Liedtke, chairman of the board and chief executive officer of Pennzoil, and included other members of management and technical experts representing exploration, production, legal, financial, and administrative functions of the corporation.

This initial formal meeting was with senior representatives of the Petroleum Corporation of the People's Republic of China. Formal and informal meetings were held in Houston and China over the next 3 years. These later meetings involved several different organizations and departments of the petroleum and related industries of the PRC.

The PRC held similar discussions with other foreign oil companies, then invited participation in geophysical surveys of eight zones in the South China and Yellow seas covering 158,000 square miles (101 million acres), an area more than half the size of the state of Texas. This survey activity began in mid-1979 and ended in 1980. Forty-six companies from 13 countries participated in the acquisition, processing and interpretation of 66,000 miles of geophysical data.

The Chinese report that the participating companies have spent, on a shared-cost basis, approximately \$200 million to gather and process the geophysical data. These costs, plus expenses for management, personnel and technology, can be considered as an entry fee into the Chinese bidding process.

With the completion of the geophysical surveys in 1980, each company received a copy of the geophysical data and was required to evaluate, on a confidential basis, the hydrocarbon potential in each survey area in which it participated. By late June 1981, the original data and computer tapes had been given to the China Petroleum Corporation and became the property of the PRC. The companies submitted 123 reports to the Chinese by the survey agreement deadlines. These reports were massive. For example, Pennzoil's 21-volume report contained nearly 1,000 maps and nearly 1,500 pages of text, exhibits and maps. Four copies of this 860-pound report were submitted to the Chinese. In June of 1981, Pennzoil also made a 4-day oral presentation to senior officials of the Petroleum Corporation and the Ministry of Petroleum Industry (MOPI).

Those companies that have satisfied their survey agreement obligations are qualified to enter the bidding for the contract areas. The overall obligations of the participating companies included data acquisition, processing, detailed interpretation, submission of a final report, adherence to confidentiality agreements, and meeting the schedule set by the Chinese.

Pennzoil has learned through the National Council for United States-China Trade that senior officials of the Ministry of Petroleum Industry are pleased with the U.S. oil companies' cooperation in the geophysical surveys and that all are qualified for the first round of bidding.

China wisely recognized the differences in national, major, and independent oil companies and included a mix of the three types in the surveys. By including the expertise, economic, and political backing of these different types of organizations, China can expect to get a creative blend of capabilities when the bidding process begins.

Bidding and exploration: The next steps.—The Chinese sent invitations to bid to qualified companies in mid-February. This invitation package contained instructions to bidders, a location map of areas for first round bidding, geographic coordinates of the areas, and a list of participants in the survey areas. Companies must apply for bidding by 4:00 p.m. March 30, 1982. Later, companies will be invited to China to receive a package containing a certificate of qualification for bidding, offshore petroleum exploration regulations, a bid proposal form, relevant tax laws, and other related documents. The bid review, negotiations and contract awards could possibly be completed by the end of 1982.

After the individual contract areas are awarded by the China National Offshore Oil Company (CNOOC), the next step will probably be for companies to conduct detailed geophysical surveys to locate specific drill sites. Exploratory (wildcat) drilling should commence within 1 year after the awards, but this will depend on drilling rig availability, an added difficulty in foreign offshore operations.

Almost two-thirds of the tracts being offered in the Pearl River Mouth Basin area will be in water depths greater than 600 feet. Semisubmersible rigs and drill ships will dominate the exploratory drilling in China's offshore.

Once hydrocarbon reserves have been established, the second phase will commence with the submission of a development plan for Chinese approval. Platforms will then be constructed, delivered and positioned for development drilling.

The development plan must include detailed specifications for development wells, production facilities, transportation, and storage facilities. In a frontier area, such as China, development from successful wildcat drilling to initial production commonly requires 5 or more years.

Second and third rounds of bidding within the four survey areas are anticipated as they mature and the infrastructure for offshore operations is in place.

Taxation and bidding requirements.—A major delay in U.S. participation in offshore China oil exploration has been the passing of the petroleum law, foreign enterprise tax law and model contracts by the PRC. The U.S. currently does not have a tax treaty with China. U.S. companies must avoid double taxation by the two countries in order to have an economic project in the PRC and also to successfully compete with national oil companies from other countries. China understands this taxation problem and has been working to solve it.

A foreign enterprise tax law was enacted by the PRC, effective January 1982, that would levy a 48.75 percent tax on most U.S. companies. This tax would in turn be credited against a company's U.S. taxes, subject to approval of the Internal Revenue Service. However, at this time the Chinese have not enacted the rules and regulations that accompany this tax law. U.S. businesses will continue to negotiate, but an income tax treaty is needed between the United States and China which would resolve the issue.

Contract terms.—Contract terms are expected to be based on similar contracts and agreements made by the Chinese and by other countries with foreign oil companies. Chinese delegations have met with representatives of all major oil-producing countries, and, in particular, the Chinese have studied the contract agreements devised by Norway, Algeria and Indonesia. Although contract terms have not been openly discussed, the basic points appear to have been established. Accordingly to the National Council for United States-China Trade, the Chinese have said the international oil companies must pay 100 percent of the initial exploration costs, with possible recoupment from future production. During the second or development phase, the cost split probably will be 51 percent for the Chinese and 49 percent for the foreign companies.

Phase three, or the production phase, has been suggested as lasting for 15 years. The Chinese also will have a royalty, probably in excess of 15 percent. The PRC has announced that they will tax the oil profits at a 48.75 percent rate which will be creditable toward U.S. taxes (if approved by the IRS). After allowing for the royalty, Chinese taxes, exploration, development and operating costs, foreign oil companies expect to receive at least 20 percent of the value of each barrel produced during the production phase.

Chinese participation plans.—The Chinese plan to provide as much of the support for the exploration and development of their offshore property as possible and will give preference to marine equipment made in the PRC over foreign-made equipment. In the past few years, China has constructed several 40-meter jackup drilling platforms and currently is building two for a U.S. firm.

China plans to spend about \$11 billion in the next few years to build new drilling and production platforms for offshore oil and gas exploration. Beijing also plans to upgrade the country's offshore rigs to international standards.

New shipyards for the construction of oil exploration rigs and oil production platforms are expected to be built in the port city of Zhanjiang in southern Guangdong province and along the Zhajiang (Pearl) River north of Hong Kong.

Guangdong Province will be responsible for onshore support of oil exploration and development programs in the South China Sea. The cities of Guangzhou (Canton) and Zhanjiang have been designated as administrative centers.

Administrative changes are being made to facilitate the offshore oil program. Chinese officials have said a special petroleum committee will be set up to coordinate the various government departments in Guangdong that provide support to the oil program. In addition to the main supply zone bordering Hong Kong, there are Shantou, the special economic zone in the eastern part of Guangdong; and Senya on Hainan Island.

Prospects and expectations.—Xinhua, the Chinese news service, announced on December 30, 1981 that "a host of data from geological surveys and drilling indicates that there are widespread and thick sedimentary rocks with mature oil-bearing layers and that more than 400 possible oil-bearing structures of various types have been found in these (offshore survey) regions. Both the Chinese and foreign geologists unanimously believe that oil reserves in these waters are very rich, (offering) good prospects for oil exploitation."

Wells drilled in the Beibu Wan (Gulf of Tonkin), the Pearl River Mouth Basin, the East China Sea, and the Bohai Gulf have had favorable results and a high success rate. Chinese officials have announced oil discovery rates in the South China Sea and Beibu Wan that exceed the U.S. new-field wildcat success rate. Although none of the Chinese discoveries have been developed commercially, the discovery rate is exceptional for frontier basins. Published reports state that recent production tests in the South China Sea have ranged from several hundred to more than 4,500 barrels of oil per day. These discovery rates and production tests encourage and justify additional exploration efforts and expenditures.

Published reports of the geological tests so far indicate offshore China will probably not be as productive as the Middle East, but it could some day rank as one of the world's major producing areas. For example, Chinese officials recently estimated that the PRC offshore recoverable reserves could range from 40 to 70 billion barrels. Estimates by Western sources have ranged from 20 to 50 billion barrels.

Expenditures in offshore China exploration and development will be large, even by today's standards, and are estimated to be as high as \$20 billion. Large oil fields with successfully high oil well flow rates must be found in order to justify expected expenditures of hundreds of millions of dollars for individual field development. To be competitive with other ventures on a worldwide basis, this type of investment requires contracts which allow a potential reward commensurate with the risks taken. The Chinese recognize these risks and are allowing American companies to participate in the future high potential, rather than act as service companies.

Up to 4 months may be spent drilling and testing each exploratory well with expected expenditures in the same cost range as other frontier areas. The cost to develop commercial reserves could approximate development cost in the North Sea. Return of the investment for development will not begin for six to eight years and it is not likely that a company working this area would recover its total investment for some years after that.

China also recognizes the extent of the financial commitment required. Bu Ming, chairman and president of the Bank of China, said, "It is our long-term and consistent policy to make use of foreign capital with discretion, to import selectively advanced technology and equipment we urgently need."

He added that China will look primarily to low-interest or interest-free loans from governments or international agencies, such as the International Monetary Fund and the World Bank, rather than seek commercial bank loans.

Economic ramifications.—China's petroleum industry could well provide the biggest source of commercial trade between the United States and the PRC by the end of the decade. The development of China's offshore oil is one of that country's most important economic priorities.

Oil is needed to fulfill China's "four modernizations"—agriculture, industry, national defense, and science and technology. This modernization program is designed to keep China an independent, economically strong country. Oil also is needed as a primary source of foreign exchange for China. This combination of internal requirements and external trade needs has necessitated an almost overnight expansion of the PRC's petroleum industry.

Although the Chinese petroleum industry has grown tremendously over the last two decades, no country acting alone can expand its petroleum industry as rapidly as China desires. Consequently, the PRC now seeks foreign cooperation and joint ventures for its extensive offshore industry. After the United States and China opened diplomatic discussions in the early 1970's, the Chinese began to seek American technology to help increase its energy production. Now China also seeks assistance in the form of management and technical personnel, supplies, equipment, technology, and money to explore the vast outer continental shelf of the PRC.

As a result of U.S. involvement in offshore China oil development, America could have access to a new and stable source of oil. This source also should help alleviate possible shortages in Japan and other countries in the Far East, in addition to replacing China's declining onshore production and allowing for future growth and economic stability.

Criteria for successful bidding.—Successful bidding probably will depend a great deal on a company's proposed work program and the speed with which it could be implemented. Companies probably will be judged by their ability to offer sound drilling proposals for geological studies and evaluation. The Chinese have said they will assess a foreign oil company's prior contributions of money and services to the seismic survey programs, the firm's cooperative attitude, and the level of technology. They also have shown they are impressed with aggressive, timely presentations of material. And, of course, a successful bid will have to be competitive with the bids of the other companies involved.

The Chinese are especially interested in meeting and getting to know the management and technical personnel of a prospective bidder. These individuals must be experienced and have the highest technical capability. The Chinese have an insatiable desire to know more about technical areas. They typically ask numerous questions and require extensive documentation and oral reports.

A company's track record also is important. Once a company has established itself as having a sound organization with significant offshore expertise and experience, future discussions and business dealings with the Chinese are much easier.

The financial requirements necessary for the offshore petroleum commitment are another major consideration. A company must be financially capable of fulfilling all its commitments to the Chinese and may be asked to assist the Chinese in locating financing.

Personal and corporate relations.—As the negotiation phase begins, personal and corporate relationships between United States and Chinese organizations need to be strengthened because patience and understanding are necessary ingredients to work on the terms of the contracts. The Chinese seem to prefer to work with old friends, those individuals and companies with which they have had previous experience. They apparently look for overall credibility, honesty, sincerity, candidness and openness in their dealings with American companies.

When negotiating with the PRC, a company should understand that the primary goal of the Chinese is to succeed for their people. A successful negotiation team also will need to display a great deal of patience.

A company should have either an employee or consultant who can speak Mandarin Chinese. Having a team member who speaks Chinese will not only speed negotiations but also will make the Chinese more comfortable about dealing with a company.

In Pennzoil's experience, Chinese-Americans with a technical background offer several advantages when a company is dealing with the Chinese: they understand the language and customs; they become instant "old friends," and they may have personal, family or professional contacts in China. Barring political differences, all overseas Chinese are apparently regarded as brothers and sisters by those in the PRC.

Dealing and negotiating with the Chinese.—To deal effectively with the Chinese, a company must correctly identify the appropriate organizations and individuals responsible for its particular field of interest. Many of the Chinese organizations overlap with two or more sharing responsibilities. Some of the organizations with responsibilities in the petroleum industry are the following:

MOPI—Ministry of Petroleum Industry: Governmental entity responsible for oil and gas industry throughout China.

POPRC—Petroleum Corporation of the PRC: Equivalent to an integrated oil company in the United States, this organization reports to the Ministry of Petroleum Industry.

CNOGEDC—China National Oil and Gas Exploration and Development Corporation: Subsidiary of PCPRC responsible for exploration and development.

SCSB—South China Sea Branch: Division of the PCPRC responsible for Beibu Wan exploration.

MOG—Ministry of Geology: Responsible for geological surveys in the PRC and earlier exploration in the South China Sea.

CNOOC—China National Offshore Oil Company: New company which represents the Chinese side in the country's joint offshore exploration, development, production and marketing with foreign partners.

The Chinese expect legal commitments that are based on equality and mutual benefit. A company must look for ways to satisfy mutual needs and goals and be very open in its dealings with the PRC.

Final contract agreements made with the Chinese often follow a series of "understandings in principle." Using this method, the Chinese go from one successive paragraph to the next as each one is agreed upon. Thus, if a disagreement occurs, then that particular part of a contract is discussed until an understanding in principle is reached.

Throughout the bidding and contract negotiation process, patience and perseverance are required by a U.S. company. In Pennzoil's case, discussions began concerning activities in the South China Sea almost four years ago and the industry does not expect to have signed contracts until later this year.

Possible problem areas.—Although the Chinese have been fair and friendly in their dealings with U.S. oil companies, differences in business practices and in the legal systems of the two countries may require many lengthy discussions or misunderstandings may result. Also, some technical areas, especially those involving computer technology, may present difficulties in translating from one culture to the other.

Chinese tradition requires that an agreement stands regardless of any mistakes made in the agreement. Thus, companies should be very cautious about making their final commitments.

The different styles in management between U.S. and Chinese organizations can lead to misunderstandings. The PRC stresses consensus by committee action. This can sometimes take what seems to a U.S. company an unusually lengthy amount of time for decisionmaking.

When dealing with the PRC, each organization contains technical, party and political members. Representatives from each of these areas must agree for a successful decision. Also, the various organizations in China are sometimes competitive with one another. This can become a problem when a company has to work with more than one organization.

Conclusions

The development of the PRC's offshore energy resources offers a significant opportunity for U.S. petroleum companies and other related American concerns. The risks are high, but geophysical and geological data indicate the region has considerable hydrocarbon potential.

China realizes that investments of high technology and financial assistance are needed to develop its offshore oil fields. If the U.S. companies do not aggressively partake of this opportunity, then other countries will gain the advantage in future trade through their representative companies.

With the installation of China's new foreign enterprise tax law and petroleum regulations, a major legislative inhibitor which has kept U.S. companies from direct involvement in the PRC's petroleum industry has been eliminated. The United States and China now need to negotiate and conclude an income tax treaty which would resolve any remaining tax questions.

If offshore China contract terms are competitive with terms of contracts in other countries, the next steps for the U.S. companies will be bidding, negotiating, contract awarding, drilling of exploration and development wells, and the production of oil.

Mr. SUTTER. Thank you very much for your clear and interesting presentation. I would hope that your slides could be made available for inclusion into the record; the graphs that you have would be particularly useful.

Mr. HOLLAND. I have colored prints available, just a few, and the slides can be lent to you if you would like to make other prints for distribution.

Mr. SUTTER. Thank you.

Our next presentation will be by Mr. Henry Groen, who was educated at the University of Utah, at Virginia Polytech Institute, and at Yale University. He served as a Chinese linguist in the U.S. Air Force and was with the Central Intelligence Agency in the Office of Economic Research in the China Division from 1970 to 1979.

Since then he has been the president of China West, Inc., and has made repeated visits to the PRC in that capacity.

Mr. Groen, please.

**STATEMENT OF HENRY J. GROEN, PRESIDENT, CHINA WEST, INC.,
HERNDON, VA.**

Mr. GROEN. Thank you, Bob.

This session of the workshop is on the practical aspects of trading with China. My colleagues here have touched on a number of points which I felt I had to cover as well, and I did in my paper, particularly with the larger trade deals in China. In any single project you go into in China you should make sure that deal stands on its own. You should not take less than market profit now, in good faith that later on you will get a better deal.

I also touched on countertrade and such. But I am not going to go over those. I am just going to speak basically to buying in China.

The Chinese right now have reordered their priorities in development. They are looking a lot more at the consumer side of things, not only for their own people but for exports as well.

They have seen over the years how the Japanese and Taiwanese and other Asian countries have made a bundle off of the West by serving our consumer market, which is a wise thing to try to do. And so first of all, we have to buy these goods from China. I think it takes a certain mindset on the importer's side to deal with China. The ones who go over with the patience we have heard about and with the flexibility we have heard about will do a lot better because we are dealing with a Communist country where change is difficult to do. In addition, the culture is quite different from ours. You have language problems and a few other barriers.

So if you frame your buying with certain goals—I will just quote here from the Chinese, it is a quote from Ji Chongwei, of the State Administrative Commission on Import and Export Affairs. These are the members of the leadership who understand importing.

He says, "The factors which determine an increase in exports are mainly excellent in quality, suitability for sale and competitiveness in prices as well as punctuality in delivery."

So we have quality, price, and delivery. Something the Chinese understand, at least some of them understand, obviously. And something which if you are a buyer you know in your every fiber that you have to satisfy. And so while in China these are your targets.

I was in Hunan a couple of winters ago, a cold place, Hunan, and I ran into a Frenchman who was trying to find out why an order of tools was late. Not only that, but some of the shipments of the tools had begun to degrade in quality. And on top of that, the Chinese were asking for higher prices. So he had to struggle with all three of these problems.

And after talking with this fellow, I went back to the Chinese and said, what are the chances this could happen to me. Well, of course, they were nil. [Laughter.]

But apparently, this contract had been negotiated back when the provinces first got a lot of authority and everybody was making deals, and some of them were not economic. This is one area that tends, when the Chinese fall down in a contract or fall back or withdraw or change after it has been signed, to shock us. Here I am a company dealing with a whole country, and here is this country, it is welching on the deal. And yet, if you think about it, in everyday life in the West, companies are changing deals all the time. It does not matter whether it has been inked.

If the contract goes sour, a company cannot take a loss from now on. So that in China you have salesmen and individuals who are doing deals just like we would in the rest of the world.

So you have to keep a certain mind set, as I say, a toughness about it. And this French fellow was tough. He had spent many years in Vietnam during the war doing business, and then he followed that up with 3 years in North Korea. [Laughter.]

So they sent the right guy.

I am speaking mainly to buyers who are going to be buying what the Chinese want to sell to us and which we should rightly buy. One way to approach it is to go to their trade fairs and see what they have. That is a good start. Then if you have a product that you want made, you find the people who are making something similar, and you begin to talk with them.

Trade fairs are not a good place to talk about price, however, because the center—the central government—would like you to believe that all prices are fixed in China. A trade fair, where everybody can watch everybody else, is not a good place to negotiate. They don't want to violate what I think is sometimes an unwritten rule, that they should not lower the price too far.

So unless the price is great, and unless you have found there is a shortage of quantity of something that you have to have, then it is a good idea to go to the provinces to negotiate the price.

Sometimes they will tell you that the price cannot be negotiated. But it can. For example, I was talking to them about a clawhammer. Well, a clawhammer sounds rather simple. But a large U.S. hardware store chain in one promotional deal will buy a quarter million of them, and sell at cost just to get people into the store.

So you get a very large distribution here for certain things. And 50 cents on a dozen hammers makes a big difference, let alone a dollar or so.

I was speaking to a provincial branch of a trade corporation, and they said, tell us the market conditions. I said, well, the market conditions are that you cannot sell this hammer at so much a dozen. And they said, we know, but tell us the market conditions. And so I am thinking, market conditions, market conditions. Of course, this is all in Chinese. So I told them the price I wanted, but it did not go anywhere.

Then a week or so later I found another hammer from another province which was priced quite a bit lower than theirs, a nice hammer, in fact. You know, I did not use to be into hammers but [laughter.]

So I went back to them and I said, listen, I have found this great hammer and here is what they want. The first province replied immediately with 20 cents lower, and they said, well, thanks for finally telling us the market conditions. [Laughter.]

So I am saying that you have to understand as much of the culture and language as is possible. It is very important, as Mr. Hoiland pointed out.

Another thing in China that we run into is something called *guanxi*. And that means "relations," basically. Everywhere in business, it does not matter, you need to be on good terms with the people you are doing business with. In China with so many thousand years of history, this is every bit as important as elsewhere, and probably more so. They have a word "*guanxi*," which it would take several paragraphs in our own language to define. Basically, it means having some pull or being in, being liked, being able to do something for other reasons than just because you have some dollars in your pocket.

One reason this is important in China is because usually the fellow you are doing business with is a salesman who is drawing a wage and that is it. He does not get commissions. He will get some kudos, sure. But he also knows he will probably sell what he is selling, if not to you, then to someone else. The talented foreign businessman in China usually keeps this in mind. There is sometimes more there than just being able to pull out the checkbook.

One other piece of advice I would give to a businessman in China is that a "no" coming from the Chinese does not necessarily mean "no." The good businessmen in China go through countless "noes" before they finally give up. Because of the fragmentation we hear about in the bureaucracy, you may find what the Chinese call a small road, to solve your problem.

Now, I am not talking about the huge problems, like the Chinese offering to pay you 8 percent on a loan and the going world rate is 17. It is going to take a little longer finding a small road on that one. But I am saying on the smaller view. And I can give you an example of this, from when I was perfecting some samples of welder's leathers. Welder's leathers are protective clothing to keep the sparks off when you are welding.

The Chinese pigskin, it turns out, is pretty good for this. It is lighter, and they have a good supply. So I was perfecting these welder's sets. They are just a cape and an apron, but also with them come bags that you hang on your belt. A bolt bag and a rod bag, they are called.

Well, after we had OK'd the samples and the prices and everything we could, delivery was figured out. I knew prices by single piece, but when I went to order, I found out that these all had to be ordered in sets. I now had a problem because not every welder wants a bolt bag.

And so I said, sets, you mean I cannot order individually? No. Why? Because bags are made by another ministry and we can sell them only if they are included in sets.

So I thought for a few minutes, and I said it would not work because I needed them all made in the same place. Well, I decided finally, and talked it over with them. How about if we have sets that have no bags in them and some have two or three bags in them? How would that work? And they said, sounds great. [Laughter.]

So we legally solved a problem caused by a bureaucratic rule. And this is what I mean when I say mind set, this is how you have to approach these sorts of problems. Problem solving is not peculiar to China. I am sure that if you trade in any foreign country, you will have to solve problems.

But, I am mainly in China, and that is mainly what I know. Why, if there are all these problems, and I am sure some people are daunted by them—it is a daunting situation—then why deal with China? I want to broaden your view a bit.

How am I doing on time, Bob?

Mr. SUTTER. I think you had better sum up soon.

Mr. GROEN. OK. Well, let me broaden you just a little bit. Since World War II the capital flight in Asia has gone to the cheaper labor areas. We have seen it go from Japan to Hong Kong, Taiwan, South Korea, and now it is really heading to China. If you do not believe it, you should see where the Japanese are investing. That is in China. Hong Kong is investing there. For political reasons some other Asian countries are not investing in China, but they certainly know what is happening.

I think personally that we should encourage buying from China. It gives them the dollars to buy from America. At the very least, we should not discourage buying from them. One thing that I think discourages it is the generalized system of preferences, the GSP, which every one of our industrial allies gives China, but we do not.

The reason we do not is because China is not a member of GATT. It does not seem to be important to our allies, so I do not see why it should be important to us. If the Chinese want to limit imports, there are a lot of other ways to do it besides using tariffs; ways that we could not easily detect.

Let me sum up now. My last subject is that U.S. businessmen have complaints and so how can governments help? I think that our Government in China should be a little more aggressive in getting information from and giving information to the Chinese. Our business community needs to know what to expect from China, but the reverse is also true.

Stanley was talking about negotiations. When you go into a negotiating situation, the Chinese know everything about you and all your competitors. But you do not know what your competitors are doing, you do not know what the Chinese are doing, and you are sort of trying to wing it. It turns out, through Adam Smith's "invisible hand," probably everybody is saying the same thing, the market forces are determining what you are negotiating.

But I think the Government can be a little bit more aggressive and ask certain questions, anticipating the businessman's problems, asking such things as, what would you Chinese consider your maximum amount to pay on some investment, and then spread the word to American firms because our foreign officers have daily contact with the Chinese and can ask these sorts of questions.

At the same time, they should tell the Chinese, listen, U.S. companies, maybe you do not want to mention company names because of proprietary problems, but you say, for example, these guys are not

going to do business for less than 30 percent, so your 20 percent is no good.

Then when the U.S. companies get into negotiations, they will appear to be presenting more of a united front to the Chinese, because China certainly presents a united front to us.

With that, I will conclude.

[Mr. Groen's prepared statement follows:]

PREPARED STATEMENT OF HENRY J. GROEN

BUYING FROM CHINA

I. Introduction

I often meet Americans traveling in China who are trying to sell. If I am on a buying trip I rarely fail to incur their envy for my easy job, as they see it. I will be the first to agree that unless your product happens to be on the Chinese shopping list, and unless they have sought out your company, selling in China is harder than buying. But the word "easy" is not properly descriptive of the buyer's job.

While buying in China a positive attitude and patience are probably the most important assets you can take with you besides money. This paper discusses some of the practical aspects of buying in China. Due to time limitations I can cover only some of the important highlights. My thoughts on the subject will be little news to the initiated, but I hope that writing these thoughts down will help to inform an ever widening circle of people interested in the subject.

Section II discusses straight purchases of Chinese goods and some of the associated problems I have experienced. Section III examines buying through various barter arrangements such as counter trade, joint venture, and compensation trade.

Following the two sections on the problems of importing, Section IV addresses the question, "Why bother with China?" Section V discusses briefly the Generalized System of Preferences and its influence on China trade. Section VI examines the U.S. Government's role in keeping American businessmen informed about China. Summary and Conclusions are in section VII.

II. The practicalities of buying from China

Under readjustment the leadership plans to push manufactures for export harder than ever. For the past 10 years this category has consistently accounted for more than 50 percent of U.S. imports from China and it will go up. High in priority are "small and medium-sized projects, requiring low investment but bringing quick economic results to help expand exports and increase foreign exchange earnings, such as in light, textile, chemical, metallurgical, machine building, electronics industries . . ."¹

The recurring leaps we have observed over the years in Chinese planning have mostly ended with mixed results as the economy has failed to advance over a broad front. Weak links such as energy, specialty metals, or even management skills can bring about a realignment in priorities a year or two later. Because of the present push on light industry and because of the disproportionately large number of businessmen involved in imports of manufactured goods, it is important for the China trader to know as much as possible about the production and delivery of the goods he is buying, especially if the contract calls for multiple deliveries.

Three necessary conditions for successful buying

A perceptive article in the People's Daily has stated that "Factors which determine increases in exports are mainly excellent in quality, suitability for sale and competitiveness in prices, as well as punctuality in delivery . . ."²

Quality, price, delivery, easy to understand, but difficult to achieve. Most important about these three conditions is to maintain consistency at the chosen level. China is learning. Last year while I was inspecting some hand tool fac-

¹ People's Daily, December 9, 1980, p. 1.

² Speech by Ji Chongwei, State Administrative Commission on Import and Export Affairs. Beijing Review, April 20, 1981, p. 15.

tories in Henan Province preparing to place an order, I kept passing a Frenchman who was also touring the factories. The Chinese separated us while on tour, but with only one guest hotel in the capital city of Zheng Zhou, we eventually got to talk to each other. He was in Henan to find out why the quality of a huge order of spanners had deteriorated, why deliveries were late, and why the Chinese now wanted to raise the contract price?

Alarmed, I confronted my hosts with the possibility of this happening to me. I was reassured that it would not. They told me that in the Frenchman's case, his company's contract had been written during the time when provinces were first allowed to make their own deals, and that the provincial branch of the trade corporation had made a bad deal. It convinced me more than ever of the importance of checking, with every entity concerned, the workability of a large contract. Inspecting the factory is important for quality considerations as well as making sure they can produce in the amounts the trade corporation says they can.

Competition among provinces can be a major factor in negotiating price. One of the branches of a trade corporation I deal with asked me on several occasions to tell them what the market conditions were. I repeatedly told them I couldn't sell their claw hammer for the price they wanted. Each time they would respond with the same question as before. Finally I found a claw hammer produced in a different province at a significantly lower price. When I told the first branch office the low price I had just found, they came back immediately with a lower price yet, saying "We are glad you are finally telling us the market conditions."

Trade fairs, general or specialized, are very convenient places to see what China is currently producing for export and to compare quality. The country is so big and travel so slow, that much time can be saved at the trade fair. The main drawback is that provincial representatives do not have the authority to negotiate a substantial reduction in price. Furthermore, it would be difficult to do if they have the authority, because fellow salesmen from other provinces are watching as they negotiate. There are price guidelines on all the products at the fair, and the last thing the central authority wants is the fair reduced to some type of a cutthroat marketplace. Thus unless the product is in short supply, or the buyer is totally happy with the price, it is advantageous to travel to the provinces to negotiate deals once the products are selected at the fair. Very often you are enthusiastically invited by the salesmen to come to their provinces to talk.

Inspection of goods before they leave China is a good idea, especially if the order is significant. The Frenchmen in the example above could probably have avoided his troubles later if his company had taken more care in the beginning, including making inspections. On small orders where an inspection trip is not warranted, you sometimes take your chances. I once ordered 2,000 silk paintings to be of varying colors and scenes, which all arrived promptly and in fine shape. What bothered me was that about 150 of them were identical paintings of a strange looking Chinese bird in a dive. I had not ordered this design, and I still have the distinct impression they were unloaded on me. If I had had a more established relationship with the salesman, it probably would not have happened. With many other handicraft items, such as cloisonne vases, all you can order are size and shape. Color and design are chosen by the seller. They say warehousing is too complicated otherwise.

Guanxi

The China trader often finds he needs to use persuasion additional to being able to place a large order. Establishing personal rapport, whether buying or selling is very important. Guanxi is the Chinese word for this type of relationship, and it is deeper in meaning than any single English word. It means having pull, friendship, or being "in."

In 1979, while developing bicycle samples in Shanghai, for the American market, I was confronted with a problem that required guanxi, and I had to develop some in a hurry. We had spent 2 weeks negotiating specifications, price, and delivery schedules of 50,000 bicycles. A contract signing banquet with national level representatives and officials of Shanghai City and the Shanghai Bicycle Company was a joyous occasion. The next day the real work began.

At high levels of government, priorities such as earning foreign exchange are clearly understood and believed in. The enthusiasm does not always filter down so clearly to factory managers. We were to work with managers of the number

one and number two bicycle factories in the country—Phoenix and Forever. Each factory produces about 2 million bicycles a year, but Chinese most prefer the Phoenix. The bicycle is as important there as the automobile and light truck are here.

Since we needed both factories to obtain the quantity of bicycles, we had to develop samples in both places. We found that number two tried harder. Everything was in readiness at Forever's factory. Frames, paint, the skilled workers, such as the pin stripe painters, all were at our service. Whereas, nothing was ready for us at Phoenix.

The manager of Phoenix could not really see why they needed to produce new type bicycles for export when they were already selling all they could make. He could not understand why they had to conform to U.S. Consumer Product Safety Commission standards, such as a 2,000-pound strength test on the bicycle chain when no one he had ever heard of had snapped a Chinese chain rated at 1,800 pounds.

The reluctant manager's logic was not faulty, and the leaders in the room accompanying us on that initial visit knew it. Bosses in China do not tell their inferiors to do as ordered, as we do in this country. There is much more discussion. The factory manager looked to me to explain why he should disrupt the factory's daily routine. And, his superiors quietly watched while I spoke. It was as if I was the only one with enough power to get the point across. It was like telling the head of Chevrolet how to run his company.

Speaking in Chinese, I explained our satisfaction at the progress so far. I explained how they could eventually compete seriously with Japanese bicycle companies for the American market and in so doing, upgrade the Phoenix factory's ability to build different models for China. We would help get the machinery to make certain coveted Japanese bicycle components. I explained how we had bureaucratic regulations which sometimes made little sense, but had to be followed as in the case of the bicycle chain. On this he nodded definitely in understanding. In the end we got the cooperation we needed, mainly I think because I had been careful to save his face in front of his superiors, and because he accepted me as a professional and not just another foreign devil looking at his factory.

Negotiating price can be frustrating or interesting depending upon your understanding of *guanxi*. Carpets are probably China's most famous handicraft. The work and skill going into one square foot of a Chinese handmade wool or silk carpet will never be duplicated in the United States for the price. The carpet salesman, who once worked the looms themselves, know this. These salesmen work for fixed salaries, if they sell today to me or tomorrow to someone else, it does not take on the urgency of wholesalers in the West. Taking time to appreciate the product, to treat the carpet people as the craftsmen they are, goes a long way to alleviate the awkwardness of economic class differences between buyer and seller. We Americans go to China to buy up the pretty things the great mass of Chinese can never afford to purchase.

The first time I bought carpets, the man assured me that I was buying at the lowest price, yet I had heard of other importers getting a lower price. After I completed my first contract for carpets, he lowered the price. With successive visits to see the carpet people business got easier. Now I have friends in the carpet industry, and both sides see value in the friendship.

No does not necessarily mean no

In China, foreign businessmen often run into an immediate reluctance when a change in the status quo, or a new idea is put forth. Usually it is the static inertia of the bureaucracy that prompts a "no" answer. Experienced businessmen do not accept the first several no's to their proposals. The bureaucracy is fragmented and sometimes fickle, and it is often possible to find "a small road" around the obstacle preventing your project.

The obstacle many times is a government regulation. Examples of the type of thinking on your feet it takes to get around unforeseen roadblocks are commonplace. Recently I perfected with the Chinese some welder's leathers for import into the United States. These sets of protective clothing are sometimes accompanied by bolt bags and rod bags, also made of leather, that hang on the belt.

Our dealings had progressed beyond the sample approval stage to the point of writing an order. Then I found out that I had to order everything in sets, even though we had negotiated individual prices. It turned out that the trade corpora-

tion I was dealing with could only make bags when they were part of a set with the clothes. I could not place an order for welder's leathers and bags individually. If sold individually, bags had to be made by a different ministry. This was possible to do, but it meant lost time, maybe not such a low price, and different leather dye lots at best.

Then I suggested that we could have differing sets. One set could have no bags. Other sets could have one or more bags. I would order the different sets to make up a mix of inventory I needed. The solution was agreed to and we went on with business.

III. Buying through compensating arrangements

Of the three most often discussed forms of cooperative trading in China—countertrade, joint venture, and compensation trade—the last appears to be the most viable at present.

Countertrade

Barter is the old fashioned name for all these terms. Of the three, countertrade is the most general in meaning. Any product or service can be traded for any other. The inflexibility of most firms to deal with anything but their own specialties prevents widespread acceptance of countertrade. On the rare occasion a U.S. company wants to countertrade its goods for certain Chinese goods, the Chinese are likely to refuse.

Ministries and bureaucratic divisions within ministries are so far apart that very little of the possible countertrade has yet been done. Countertrade from the overall national view makes sense for the country, but from the single ministerial view it has not been attractive to the Chinese. Leave alone all the stepping on toes it takes to cross administrative lines, the idea of one department swapping significant quantities of a product good enough to be sold in the world market to pay for a set of machinery going into another department, just does not sit well with those giving up their products.

Being compensated in domestic currency is not desirable either, even at the higher internal exchange rate of 2.8 yuan to the dollar. Accumulating foreign exchange is the name of the game when every industry has a long shopping list for foreign goods but a limited bank account. Most experienced China traders do not foresee this problem being solved in the near future.

Joint venture

The joint venture concept is also floundering. The Chinese government is too worried that a foreign partner will make too much money. In these modern times, exploitation is still a real Chinese fear. The foreign partner, on the other hand, is afraid of not making enough money.

Tax issues are not clear. The calculation of profits and costs is a gray area. Management ground rules are not firm, and could be susceptible to change for a long time to come. One detraction in the decision process is that much must be cleared with a factory's Communist Party Committee. Until a track record is established with some small joint ventures, few foreign companies will enter into large ones.

Compensation trade

Compensation trade is a specialized form of countertrade and has been the most successful form of cooperative trading. Under compensation trade, the foreign firm provides equipment or a loan for such materials and technical expertise in any combination. The Chinese side then repays principal and interest with products produced with the new equipment or materials. The whole deal is within the scope of the foreign partner's expertise, or at least the marketing of the products is. Signed compensation trade contracts so far mostly have been small light industrial projects. The large projects now being negotiated, particularly in the extraction industry—fuels, minerals and metals—are taking inordinate amounts of time.

Several undercurrents need to be kept in mind to understand why the large projects move so slowly. Few, if any, Chinese leaders can or would make a major business decision by themselves. Recent history has proven to every leader in power the risk of isolating oneself for a cause. Recently during a negotiating session in Peking concerning a large mine project, I was told by a middle ranking participant that to obtain changes we wanted in the Chinese proposal, he would have to get a whole new series of signatures up the chain of command. It would

take extra long because two of the necessary people were out of town, one of whom would be gone for a month.

The Chinese appear to excel at negotiating from a weak position. Most of the time it is no special skill. They just have no fall back position, and the foreigners get tired and give in, or they go home. The below market rate of return on investment that China usually demands has killed many proposals. There are indications that they may have started taking a more realistic view of what a western company needs to earn on investment to make the deal viable. At present, an American company investing in metals extraction, for example, would have to earn at least a 25 percent return. This is the opportunity cost of capital invested elsewhere in the world. With the added risk in China stemming from the uncertainties of readjustment, an American company should try to get 30 percent. These rates of return dismay the Chinese, but in my opinion, they will eventually be agreed to.

Chinese corporations within industrial ministries, having very little experience, are now in charge of negotiations for large scale projects. Ministry of Trade officials still take part in negotiations, but they are minor players. The inexperience and the shifting of power away from the Ministry of Trade to the producers complicates negotiations. I have seen the dissatisfaction of the trade officials in these meetings. What makes the situation sensitive is that although the Ministry of Trade may have no control over the specific quantity of a commodity, like coal, they have a strong say on price. Without their cooperation, at present, no deal can be made.

The mechanism for setting the price of a commodity, which may need to be paid back for seven or eight years, is critical to a compensation contract. In the case of coal, China has asked that the price be renegotiated each year based upon what Japan and Southeast Asia is paying for Chinese coal at the time. Having watched the price of coal rise as much as 50 percent per year, the Chinese worry about the foreign investors making windfall gains. Foreign firms, however, usually want to fix the price of a commodity for the entire period of repayment, or at least fix a maximum rate of growth of price. This avoids the grim possibility of failing to reach agreement on price in future years. The solution to price will probably be through some form of indexing to world market prices.

One tactic of the Chinese, while negotiating difficult demands, has been to indicate that if the foreign firm makes low profit on the first deal, it will be alright because there will be great opportunities for profit in the future. They will have become an old friend of China.

Good advice for any U.S. company doing business of this type is that each deal should stand on its own. The contract is unstable if one side is not earning a reasonable profit. China's course of economic development needs a maximum amount of stability and will derive maximum benefit from normal, economic business decisions on both sides.

IV. Why bother with China?

Communist countries present unique problems to U.S. international businessmen. Excluding the ban on certain high technology and strategic commodity exports by our own country, the source of most of the obstacles to trade is the Communist government bureaucracy. Additionally, in China, there is an extreme language barrier, and little common cultural background.

Communist countries account for one third of the world's population. China alone accounts for one quarter. Since reopening trade with China in 1972, U.S. exports to China have grown to 45 percent of U.S. exports to all communist countries. This has happened in spite of a chronic shortage of foreign exchange and the problems mentioned above.

China differs importantly from the Soviet Bloc in that China is no military threat to us or our allies. We shouldn't have to mull over the wide range of high technology items that China can buy from our allies, and that we produce at a comparative advantage in this country. Even so, the list of unrestricted goods and services China needs and will buy from the United States is huge. But they can not buy from us without the dollars.

In 1981 China ran a trade deficit with the United States of \$1.7 billion. It does not seem significant compared to the deficit the United States ran with Japan of \$15.8 billion, nine times the China-United States deficit. But the \$1.7 billion is just as significant to China as the \$15.8 billion is to the United States. Our GNP at \$2.7 trillion is ten times larger than China's GNP at \$267 billion. Just as we have now begun to look hard at glaring bilateral trade deficits, so has China always paid close attention.

If we buy more from China, provide them with more dollars, they will buy from America. For the foreseeable future their demand for our products will outreach our demand for theirs. Regardless of how fast we increase our imports from China, the likelihood is that we will continue to run a trade surplus with them.

As trade with China grows, imports of manufactured goods will probably grow at a higher rate than total imports. In some specific categories of manufacturing, where China becomes strong by U.S. standards such as in textiles, protectionist forces will come into play as a matter of course. But in general the increase in manufacturers will not seriously threaten U.S. industry. The Chinese threat will be to Japan, Taiwan, South Korea, Hong Kong, and Singapore.

Since World War II investment capital in labor intensive industries has flown from one Asian country to the next as wage rate increases have followed. Japan and the Gang of Four, as these four Asian countries are sometimes called, have been fertile ground for cultivating imports. As markets for U.S. exports, however, these five industrial Asian nations have been less than satisfactory. Shown below are U.S. trade figures for 1981.

[In millions of U.S. dollars]

	Exports	Imports	Balance
China.....	3,602	1,892	+1,710
Japan.....	21,823	37,612	-15,789
Taiwan.....	4,304	8,049	-3,745
Hong Kong.....	2,635	5,428	-2,793
South Korea.....	5,115	5,141	-26
Singapore.....	3,003	2,114	+889

In 1981 I conducted a sizable mail survey of U.S. firms in the Fortune 500 doing business in China for my article in the forthcoming Joint Economic Committee of Congress study on China.³ One of the findings was that U.S. firms on the average were disappointed at the slowness in the progress of the China market, but only a very low percentage of companies were considering cutting back efforts there.

The general economic attraction of China to U.S. firms, even with readjustment, is the feeling that something good is happening there. The demand for western trade is tremendous, and most important, China is raising its ability to pay. The land area is large, just about equal to the United States, and there are immense natural resources, in sharp contrast to the other East Asian countries. China's industrial base has reached significant proportions and is expanding steadily. The population is industrious and educated.

The United States is showing unprecedented concern about bilateral trade deficits, particularly with Japan. Threats of imposing trade barriers unless Japan opens up its market to U.S. goods result from exasperation more than from clear thinking, but it is understandable. Complementary U.S. policy could be to encourage the switching of American imports from Japan, Taiwan, and Hong Kong to imports from China. At least imports from China should not be discouraged by uneven treatment like granting its main competitors GSP status. China will come back to America with the dollars and buy. Our trade with China is pushing our lopsided Asian trade balance in the positive direction.

V. Generalized system of preferences (GSP)

America is the only major industrial country that has not given China GSP-type tariff treatment. The Trade Act of 1974 enumerates lengthy preconditions that developing countries must meet to qualify for GSP. China's only failing by U.S. standards is that it is not yet a contracting party to the General Agreement on Tariffs and Trade.

Other major countries endorsing GATT do not require China to join GATT to qualify for their GSP. This is logical because in a Communist country, where the government owns the means of production and does all the importing and exporting, tariff levels have little effect on a foreign country's ability to sell its

³ "U.S. Firms in the PRC Trade (The Sweet and Sour China Market)", China Under the Four Modernizations, Volume II, Spring 1982.

exports there. If China needs something, they buy it. The money all comes out of the same pocket. If China were a member of GATT, it could show a tariff schedule with very low rates, but if the central planners wanted to discriminate against certain foreign goods, they could limit imports through any number of measures difficult to police.

Excluding China from GSP, while including Taiwan, Hong Kong, and other Asian countries, distorts America's role in the economic flow of trade in the Pacific Basin. Our higher tariff on Chinese goods compared with our western allies handicaps us in competition for the China market.

The main reason for GSP is to help a country with its economic development. Were China a small country, the implications for the future would not be significant. The reality is that the developing of China into a modern industrial power presents America with economic and political opportunities which we should waste no time taking advantage of. Legislative matters such as GSP should be corrected.

VI. The flow of information in China

Foreign information collection by government has been described as a newspaper company in reverse. A newspaper company is a few collecting information for many. Government is many collecting information for few. I think government can improve the flow of useful commercial information about China, not just back to Washington, but to the American business community.

American businessmen are at a heavy disadvantage in China where information is concerned. A foreign trade corporation there knows every competing company's proposals whether buyers, sellers, or investors. The Chinese keep the foreign companies in the dark about each other, and even admonish them not to tell others including their government about business. Of course a certain amount of information is sensitive to exploitation by the competition, but probably not much is.

The result of having poor information is wasted time and money. As an investor in a Chinese project, I would like to know what the expected rate of return is on projects in China. I would also like the Chinese to hear from someone other than private firms if conditions for business are not right. Chinese should hear from American companies and government what our needs are. The more broad the front we present, the more successful we can be.

Commercial officers in our embassy can help free up this type of information by getting closer to the action. Never mind that back in the States government and business are adversaries, this is China. Embassy officers in China have a great opportunity to push U.S. business. They have the language and enough of a commercial base to really get in and work. A measure for success would be having to spend too much time talking to U.S. businessmen coming to China. Then the embassy could put out a business newspaper from Peking.

VII. Summary and conclusions

Buying from China is not as easy as it might first appear. American businessmen are having to learn how to think like their counterparts in this centrally planned country, and to cross cultural boundaries, if temporarily, to succeed in making deals here. China's dearth of foreign exchange dictates that we buy from them if we want to sell.

Countertrade makes sense from a national standpoint, but the ministries have as much trouble with barter as U.S. companies do. Joint ventures are progressing slowly and only on a small scale, because there are foreign as well as domestic uncertainties about their workability. Compensation trade, where western firms invest in equipment and materials and take back products they already sell, is presently the most successful form of cooperative trade.

After 10 years of United States-China trade the record shows it has been worthwhile. U.S. firms are committed. China has reached a point of industrial development, backed up by their large natural resource base, which America cannot afford to ignore. Trade law inequities such as the uneven bestowal of the Generalized System of Preferences introduce distortions that hinder smooth transitions in trade flows, and hurt us more than they help.

Information in the international market place is imperfect at best, but in China where the government plays foreign firms off against one another, American companies could well benefit from improvement in U.S. Government commercial information gathering and dissemination.

Mr. SUTTER. Thank you very much. I think you have a particularly interesting perspective, and your experiences in China serve as a useful summing up of many of the complexities that we talked about today.

I find that in our sessions we have set forth this afternoon a number of rules of thumb for dealing with China. We have many suggestions, and I think most of them are complementary. I do not see too many contradictions in the ones that I have been able to note. In addition, we certainly see offshore oil development, as a big area of future cooperation with China.

Are there other areas that we should be considering as far as an area of future cooperation with China? And do you have any comments among yourselves about some of the rules and other issues that were raised by some of the other speakers?

[Pause.]

Mr. SUTTER. One area we have not mentioned, for example, is agricultural trade. We talked a bit about that this morning. Can we expect that to continue to grow?

Mr. GROEN. I have a thought about it. I think all of our deals have been at the national level in China. I know there has been decentralization and recentralization. But the provinces many times know what they need most in terms of agriculture. I believe for the U.S. farm products on the provincial level there is an untapped demand. It is something that our agricultural people can think about and work on. Our business people can work on it.

I know if I get a chance to talk, say, of trading coal for soybeans, I certainly would. Commodity barter at the provincial level may be a way around the foreign exchange control problems.

But I think on the provincial level we do have a chance to sell U.S. agricultural products.

Mr. SUTTER. Mr. Tallas.

Mr. TALLAS. I think from what we heard this morning from Nick Lardy it is clear that the United States will have a very large agricultural market in China for at least 3 to 5 years, given the announced policies of the Chinese Government, the purchase of grain for distribution in the coastal urban areas, as opposed to trying to distribute the grain which is grown in the hinterland.

However, I am a little bit more pessimistic about the size of the future market opportunity than Jay is, because I think the purchase of grain and the allocation of foreign exchange for that purchase is something that is going to be controlled by the central government and will be closely controlled in a central plan for all imports, not just agricultural imports.

The previous question is what other areas offer opportunities for the United States. Well, we could sit here now and probably come up with a quick list but that surely would be incomplete what with the large number of industries and products which represent a market opportunity, whether export or import.

What is important is that China is a developing country, it is a country of a billion people. A billion people, 60 percent of that number, is below the age of 30. A population which we heard this morning has rising expectations. The Government is committed to raising that standard of living. And it is not a small job to be able to do that in a

country like China, given the economic base and the infrastructure that they have.

Between a country like the United States, which is well developed, industrialized, and a country which, like China, with all of its developmental shortcomings, there obviously is a natural fit here, particularly since China is well endowed with natural resources that the United States certainly could use, whether it be oil or rare metals or what not.

But as Jay has pointed out, you have a country where unemployment, admitted or disguised, is a very large problem. This is a country which is committed to putting those people to work. Is there any doubt or can there be any doubt in anybody's mind that if there is an export market for China in the world, whether it is in the United States or anywhere else, that China cannot be the lowest cost producer for light manufacture?

I think that we are going to see that more and more of the commodities which in the past 10 years have been sourced in South Korea and some of the other Asian countries will be coming from China. China represents a very large market for technology and other goods and services from the United States. In turn, it represents an enormous market for sourcing of a product at a low cost.

In our hurry, our anxiety to boost our sales, I think a lot of companies are missing a great opportunity to establish source relationships.

Mr. SUTTER. Mr. Sullivan and then Mr. Denny.

Mr. SULLIVAN. I think I would agree, with one footnote, to the view that our agricultural exports to China will not continue to grow at the rapid rate they have grown in the past. But I would not expect to see any great falloff. We are, however, seeing some considerable drop in cotton exports, which I suspect is a little political reminder that the Chinese are buying an awful lot of cotton from us and are running into obstacles to the sale of textile products in the United States. They are doing the same thing in synthetic fibers.

In 1980 China bought 54 percent of all of the synthetic fibers sold by the United States abroad. This year they are saying, thanks a lot, but if you are not going to buy our fabric, we do not need your synthetic fiber.

I think when these problems are negotiated, we will see that the agricultural exports to China, which have plateaued out, will continue to grow but at a more modest rate as the Chinese standard of living increases, as the taste for wheat continues to spread as it is spreading in China, as the Chinese perhaps move to importing some feedgrains and that sort of thing. Opportunities for substantial growth in American sales to China will have to come from other fields. I think we will see that in the whole energy field.

We have not mentioned a very important field in energy, which is the energy conservation area. The Chinese are well aware that it is going to be 5 or 6 years before they begin to see much new energy supply coming either from oil development or from coal.

But in the interim, if they are going to continue to grow economically, they have to find ways to improve their efficiency in the use of energy. And the Chinese, as I think most of you are aware, are prodigiously wasteful users of energy. That whole area presents great

opportunities for American companies in terms of selling more efficient equipment to the Chinese.

One concept that I would like to throw out here is one which I do not think has really been discussed. China is quite different from Korea, Taiwan, Japan, and Southeast Asia. While there are some superficial similarities, in terms of low-cost labor and so forth, it is also a continental power. I think this affects its whole attitude toward trade. We will not find China and Chinese officials preoccupied with trade the way we found the Japanese in the 1950's or the Koreans a little bit later and the Taiwanese a little bit later on.

As a matter of fact, I think we may find, and some businessmen are finding today, problems in getting Chinese factory managers and Chinese government officials to make any changes in order to improve trade, not just because they do not make a profit themselves, but because if they cannot sell it to you, they can sell it in Szechuan.

In other words, their attitude toward trade is going to be very similar to the attitude of a lot of American businessmen toward trade, which is, big deal, I have a big market in New Orleans and I do not need you. So I think that is an aspect of the economic relationship which we have not really talked about.

The other one which comes up all the time and which, given the deficit that the Chinese run with us in trade, seems to be more of a problem than it really is, and that is the question can the Chinese pay for all of this?

I would just mention, though I do not have the figures in front of me, that it is a little-known fact that China's foreign exchange earnings are growing. Despite the deficit with us, the Chinese are doing quite well and are coming close to \$10 billion in building foreign exchange. Their foreign exchange reserves are actually growing for a lot of reasons, not the least of which is they make quite a lot of foreign exchange from services such as shipping and such things.

Mr. SUTTER. Mr. Denny.

Mr. DENNY. For good reasons, we are all focused very much on oil. But as Roger Sullivan and Bob Dernberger have emphasized, our focus and our context really should be the larger energy picture in China. In each one of these areas, the Chinese are extremely active and there is every indication that they already have been working considerably with American companies.

Let me give you some examples. Aside from the oil, there are three American companies which are deeply involved in the joint venture negotiations with the Chinese for a major open pit coal mine in China. In the hydropower area, we have a government-to-government agreement with the Chinese. Separate from that agreement, the Chinese through the World Bank have recently contracted with an American company to do a feasibility study for one hydropower project in China. And there is some hope, based on a recent visit by a Commerce official to China—who is the national coordinator on our side for this government-to-government agreement—that we may be able on a government-to-government level to focus on one Chinese hydropower project and involve our private sector in work on that particular site.

Finally, and I think further down the road, the Chinese have an obvious interest in nuclear powerplants and, again are very actively discussing this with American firms, among others.

So I just wanted to put it in the more general context in which it appropriately belongs. I think, that in this priority area of the Chinese economy, American firms are very deeply involved already.

Mr. SUTTER. Thank you.

Dr. Hardt.

Mr. HARDT. I would like to make some critical remarks in a comparative sense. If we think of the present projections as not too dissimilar to those we were making 10 years ago in Eastern Europe, and think in terms of contingency planning—that is, things might not go well politically and economically—then I would wonder what about the financial trinity of rescheduling, conditionality, and default, or the legal problems of government restrictions, sanctions, embargoes, or even more modest things. And how does force majeure apply in contracts related to government action.

I would also note that one of the things that is anathema in Western trade, Western trade with Eastern Europe and the Soviet Union, is countertrade. We have presented this as an issue at Madrid in Basket 2 discussions. We do not like countertrade, and there are lots of reasons for not liking it. So we may find that the proposals for countertrade that may be useful as they expand may become problems to us.

Also, if the country does not expand its hard currency earnings capability, as you suggest, one of the things the East Europeans are doing now is cutting down on their grain imports. That is an area in which they are particularly interested, not in feed grains so much, because that is something they cannot do so much about, but self-sufficiency in cereal grains is definitely a target because of comparative advantage.

So I wonder if it is not prudent to have a little contingency planning in the event the market is the sour one rather than the sweet.

Mr. SUTTER. Mr. Woodard, please.

Mr. WOODARD. I would like to raise one issue that I do not think has been discussed in any depth here today, and that is the question of Chinese participation in enterprises that are set up in cooperation with American companies.

I am particularly involved in this particular area in the offshore, but it does apply to a broad range of industries. Beijing basically appears willing to experiment with almost any form of joint venture, coproduction, countertrade, et cetera that involves a significant—and this is important—growing level of Chinese participation.

They see this as a method of training, technical training, for their own people and also, of course, as a method to promote technology transfer. Yet, these arrangements, sometimes at least, cause some consternation and resistance from American companies. And this is particularly evident in the petroleum industry.

For example, if an American drilling contractor wants to go in on contract with Exxon or with Pennzoil to drill offshore China, do they have to become a joint venturer? Can they operate a wholly owned subsidiary? What happens to the legal title to the rig that goes into Chinese waters? Under what title does it come back out of Chinese waters, et cetera, et cetera?

From the side of the exploration company, on the other hand—and Scotty Holland might want to comment on this—must Pennzoil

take a Chinese rig in order to drill in its contract area, or must it buy through Chinese suppliers? Will the Chinese suppliers be fast enough and have the right logistical arrangements back into Houston or back into whatever manufacturer in order to be able to provide the right equipment to keep that very expensive rig operating on its normal schedule on the shelf?

Again, these are areas that I am aware of from the petroleum industry. I know that they do apply in some depth in other areas of trade as well.

The offshore petroleum regulations specify preference for Chinese services and supplies where competitive. But they do not dictate a rigid joint venture framework. I think that this is a step forward.

Is the preference clause a better alternative for most companies outside of the petroleum field than joint venture, and what would it imply? Is the People's Republic of China, on the other hand, willing to permit operations of wholly owned foreign subsidiaries on Chinese soil? And if so, under what conditions?

So I would just like to raise the issue. I think the issue of how to involve the Chinese and how to manage the operational relationship on the ground in production relationships with the Chinese is a terribly important one and an area that has to be managed well in the commercial relationship over the coming years.

Mr. SUTTER. Thank you.

Mr. Lubman.

Mr. LUBMAN. A few points. First, I want to underscore the importance of Greg Tallas' proper focus on China as a source of products.

In response to one of your questions, Bob, I think it is true that China is a very large potential source, a natural source now, of light industrial and textile products, particularly light industrial products. Here my knowledge is derived less from my experience than that of my wife, Judith, who in running a trading company in the China trade has been engaged in this type of product development.

However, I would like to point out that the very products which can be so effectively sourced in China are those which can also find themselves subject to protectionist restrictions in the United States.

And I think that there are very profound implications for U.S. policy in this matter. Senator Hayakawa, I think, raised this earlier today. On the one hand, as I see it, we have to weigh the advantage to the American consumer of making available high-quality products which are price competitive even if they are from abroad. In addition, as others have already pointed out, if we continue to enlarge our purchases from China, it is likely that China will continue to be a good market for American products, thereby creating jobs or helping to maintain jobs for American companies manufacturing those products.

Yet, we must balance that against the possible damage to American companies which find themselves unable to compete with those cheaper Chinese products.

It seems to me that what is basically involved is whether this country will adopt protectionist barriers against products which affect and injure American companies or, on the other hand will follow some of the policies already expressed in U.S. law; that is, to give adjustment assistance and to make other arrangements to assist companies which have been injured.

There is a trend in this country toward protectionism, which I find rather alarming. This question is one of policy which the Congress is going to have to address. We have already seen a number of problems appearing in the short years in which Chinese exports to the United States have been rising, for instance in textiles, but in other areas there are already prospects that these kinds of problems will be raised.

John Hardt asked about force majeure and its effects. I think you asked whether government action would be considered as force majeure. China, I am sorry to tell you, is not a monolith in this regard either, and I have found different reactions on the part of different Chinese negotiators. The standard Chinese force majeure clause is one which is meant to apply to what are outside China, or at least in the Western world, called "acts of God," and which in Chinese contracts are frequently called "acts of nature."

There are big differences between those who would have very short force majeure clauses which make it clear that storms, fires, earthquakes, and similar instances are considered as suspending the obligation of the party who is affected. There are other Chinese negotiators who will agree to listing more events, although not plagues of locusts, squirrels which short out powerlines, and all other hypotheticals thought of by inventive Americans and other foreigners.

So far as acts of government are concerned, I have encountered a resistance on the part of negotiators to include acts of government. However, some negotiators have been willing to do so, either as part of a force majeure clause or as part of a separate "act of government" clause.

There has been some occasional receptivity to treating a specific act of a government—denial of an export license—as an event which would excuse the party from delivery.

Third, Kim Woodard mentioned a number of issues having to do generally with joint ventures, more specifically to petroleum-related issues. I am not going to comment on the petroleum-related ones because there is a real petroleum expert here. I would, however, make a couple of points on joint ventures generally.

There has been a great deal of attention given to the Chinese joint venture law, particularly to one provision which states that important questions must be decided through consultation. This clause does not refer to the percentage of ownership by either partner.

This clause is a very clear expression of the Chinese attitude that regardless of what percent you or they own in a joint venture, you are partners and unless you work together as partners, the joint venture will not work. That means there must be a considerable amount of interaction, in fact, maybe even more than one might expect in joint ventures elsewhere.

The Chinese also make very clear that they want technology transfer to be done within the framework of the joint venture, whether there is a technology transfer agreement or a license agreement such as those which have been negotiated in the context of agreements like that for the Jardine-Schindler venture for the production of elevators, and even if there is no proprietary technology but just a lot of know-how in running a factory.

The Chinese, quite rightly, it seems to me, expect that know-how to be transferred to the Chinese side. And that means, and I think you

agree from what I gather, that the American company or any foreign company which wants to engage in a manufacturing joint venture in China must expect to include a fairly considerable component of training, including management training, for the Chinese side.

That is a way of demonstrating the effectiveness of the partnership, and it is also a way of making the partnership more effective.

Mr. SUTTER. Thank you very much.

My colleague, Broadus Bailey, has a question for you.

Mr. BAILEY. It is somewhat of a change of subject, but I get the impression that there is a need for the U.S. Government to collect more information on China and make it available to American businessmen. On the other hand, I get the impression from Mr. Lubman that there is a good deal of information, perhaps an adequate amount of information, available.

And I wonder if we could explore that for a moment. It is certainly an area in which the committee might be interested, particularly the International Economic Subcommittee. It could be of assistance. But it is not quite clear to me what the consensus might be on that score.

Mr. LUBMAN. If I may respond, I think we were talking about different kinds of information. Let me distinguish. The kinds of information that I find available, often in greater quantities than one might want, is raw data about the Chinese economy. Those of us who specialize in this business know that every day hundreds of pages of Chinese radio broadcasts and newspaper articles are translated and made public by both the Chinese and the U.S. Governments. There is, in addition, a wealth of secondary information in trade journals and research done by academics.

A great deal of information about particular Chinese industries is contained in that material, and it is the kind of information that an American company can hire somebody to sift through and analyze for it. I am not sure that the U.S. Government or the U.S. Senate need be in the business of gathering that kind of information, although the Joint Economic Committee has published very helpful and informative industry surveys in its triennial volumes on China.

The National Council for United States-China Trade collects this kind of information and I believe makes it available to its members and also to nonmembers.

The Department of Commerce does the same. I think the kind of information that it is probably very hard to ask the U.S. Government to try to collect is information such as Mr. Groen talked about; that is, information on policy especially with regard to specific business transactions.

Roger, perhaps you might correct me on this, but I have the feeling that the Chinese do not particularly like the U.S. Government to be involved in specific business transactions. I just do not think that it would be very useful for the Embassy in Beijing, for instance, to spend a great deal of effort trying to help out in particular business transactions. I am not even sure that it is supposed to be doing this, outside its usual general facilitating role.

The Chinese are somewhat reluctant to discuss information on policy except in somewhat general terms with Government representatives. The kind of information which Mr. Groen discussed, relating to particular business transactions—at least I think somebody implied

that—would be very hard for the U.S. Government to collect on behalf of individual companies.

Mr. SUTTER. Mr. Groen.

Mr. GROEN. I would say at this point, yes, it would be hard to start doing that.

However, if you want to compare the Japanese effort in China, with their Ministry of Industry and Trade [MITI], I think there is a lot closer relationship between industry and government there. And when Japanese Government leaders go to China, I would not be surprised if they were pushing Japanese business a lot harder than we tend to.

I think that if we started, and became a bit more aggressive, the Chinese would get used to our commercial sections asking so-called sensitive questions, which seem sensitive on a 1-to-1 relationship with the Chinese in a negotiating session, but which turn out to be common to all U.S. companies competing with each other in China. Without infringing on competition, our Government could get this common knowledge out in the open more quickly, and save everybody time and money.

I think that if the United States, as I put it, were a little more assertive in trying to think ahead to the needs of our companies in China, to ask likely questions before they come up, U.S. firms can be more effective in China. Maybe the Chinese will say no to our commercial officers, but maybe they will get used to our asking and cooperate.

Mr. SUTTER. Yes, Mr. Sullivan.

Mr. SULLIVAN. Well, I hate to say this, having spent most of my career in the government, but I think not only would the Chinese not particularly welcome this, I am not sure American business would welcome it either. And I think I know why. The kind of tight cooperation you see between the Japanese Government and Japanese business works well in Japan for a lot of historical and cultural reasons that unfortunately do not seem to apply to the United States. So while in concept I think it would be nice if we had that kind of cooperative relationship, the fact is we do not. I think we ought to have more modest objectives. One would be just simply ending the adversary relationship between business and government.

But the second one is really the one that dominates conversations in the private sector, and that is that the government quite frankly is behind the power curve. In most cases the request is not that the government positively assist business but that it get out of the way and let business operate. We will be talking more about this in detail tomorrow. But to the extent that government is really helpful to business, it is generally when it decides to remove obstacles that it has put in the way.

Mr. SUTTER. Thank you.

Mr. HEGINBOTHAM, please.

Mr. HEGINBOTHAM. I hope I can say, Roger, that I think the National Council is behind the power curve when it comes to the development of government-business relations, because one of the things I have been very deeply engaged in for the past 2 years is to develop that kind of collaborative relationship between business and the U.S. Embassies, particularly in Asia.

In fact, we have selected, as I am sure a number of you know, as our commercial counselor in China, Mel Searls, who was formerly associated with your organization, has been both in the energy and the construction business, and has to be able to bring to that job, along with a knowledge of the Chinese language, a credibility in being able to discuss and identify opportunities for American business.

In addition, of course, we are trying to move people with a business background into positions in our consulates in China and, I would emphasize, in Hong Kong, which I think we have not discussed enough in terms of the China relationship here today. We have as commercial counselor in Hong Kong a businessman who again has done a lot of China business on his own.

So I think we are positioning ourselves in a way that will permit us both to gain some credibility and to be more effective in identifying some of the business opportunities in China.

I would be willing to say that certainly what you said was accurate for the time several years ago when you and I worked together.

Mr. SULLIVAN. If I may comment, I do not think I stated my position very clearly. I did not mean to disparage any work done by the Foreign Commercial Service and the Embassies. I was not talking about that kind of government assistance. I was talking about it on a policy level, that the U.S. Government, either the executive branch or the Congress, would decide that it was going to embark on some great effort to help the American business community in some way. Certainly, the services that are provided by the Foreign Commercial Service are most welcome and very useful.

Mr. SUTTER. Mr. Holland.

Mr. HOLLAND. I would make a quick comment, Senator. If you wanted to embark on any great thing for American industry, it would be a tax treaty between the United States and China. You were not here a moment ago, Senator, when I made my presentation and mentioned the importance of a tax treaty. It is very important to oil companies so that we can start committing funds.

Senator HAYAKAWA. A United States-China tax treaty?

Mr. HOLLAND. Yes. The United States should move ahead in getting a tax treaty between countries so that we can have creditability for our taxes; that is, money or money against tax credits.

Senator HAYAKAWA. I had been moving in that direction 2 or 3 years ago. I think I will try to take another shot at it.

Mr. HOLLAND. We can do all the talking we want to about this issue. We can talk about our trade and everything else. But until we have a way that we do not get double-taxed, we cannot compete with the national oil companies of these other countries.

So we were talking about getting something going and helping through the power structure. You are the ones who are going to have to give us the power structure through the tax treaty.

Senator HAYAKAWA. As I recall it, California has that unitary tax. Alaska has it.

Mr. LUBMAN. I think Mr. Holland's reference is to a bilateral tax treaty.

Senator HAYAKAWA. Oh, then that is something else.

Mr. LUBMAN. Yes, sir, that is a different question.

Senator HAYAKAWA. Well, then explain that to me.

Mr. HOLLAND. I will let the lawyer explain it. But as a businessman I need it so I can go ahead and move ahead to make investments.

Mr. LUBMAN. I think the petroleum specialist knows more about this particular tax issue than this lawyer does. But the issue is very simple. The question is whether the taxes just enacted by the Chinese Government will be creditable against U.S. income tax paid by the U.S. companies. If those taxes are not creditable, then the American companies cannot be competitive.

The Chinese, in drafting their tax statutes certainly had the benefit of more discussions than the mind would want to conceive of the Internal Revenue Code with the oil companies and with a number of American lawyers.

There also has been, I think, a very useful interchange between the Chinese Ministry of Finance and the U.S. Treasury.

Senator HAYAKAWA. Excuse me. Are they taxed once by China and then again by the United States?

Mr. LUBMAN. That is their concern. The tax has just been enacted, and we do not know yet. The Chinese have drafted the tax with an eye to present U.S. laws so that the tax is a tax on net income. The tax is distinguishable from a concession, which would make it not a creditable tax.

However, the Internal Revenue Service has not yet ruled on whether the tax is creditable. Once the Internal Revenue Service rules on that and the tax is creditable, there are still other technical questions that have to be resolved and which are customarily resolved by bilateral tax treaties.

Senator HAYAKAWA. Does this apply to oil companies?

Mr. LUBMAN. It applies to everyone. It applies to individuals, it applies to oil companies, whether they do business as joint ventures partners or not.

It is an issue that applies all across the board. It happens to be a pressing one for the oil companies because of the imminence of the bidding. But it is a question that affects all Americans doing business in China.

Senator HAYAKAWA. Thank you very much.

Mr. SUTTER. Ms. Haas.

Ms. HAAS. I am Patricia Haas, and I am with the Treasury Department. I am not on the tax side of the Treasury Department, so I cannot speak as an expert, but there have been discussions with the Chinese for the last 3 years on tax issues.

My understanding of things as they stand now is that once regulations are issued for the foreign enterprise tax zone, which I understand should be forthcoming this week—

Mr. LUBMAN. They were issued several days ago.

Ms. HAAS. And we should be getting a translation in a few days. Then they undoubtedly will be submitted by the U.S. taxpayer to the IRS for a ruling, at which point I am sure the IRS will explain the ruling.

This should answer a lot of the questions pertaining to creditability. This can be done fastest probably this way rather than through a bilateral tax treaty.

But discussions have also begun on a bilateral tax treaty, and we expect negotiations to begin on that treaty perhaps this spring. We are waiting right now to hear from the China desk.

Mr. HOLLAND. The only reason I brought it up is because we just received word that once these applications to bid go in, which is at 4 p.m., March 30, then you tick off a time of 100 days after that point, after which you have to make bids.

That is critical because when you are thinking about what you are going to do, first is the tax implications, you are going to have to be serious when you start talking about your work programs, which are big bucks. That is the only reason I mentioned it. These things are moving pretty fast.

Mr. SUTTER. One thing that Mr. Tallas raised, which I thought was particularly interesting, is related to what we were talking about this morning, and that is the need for good political relations and how that affects our economic ties with China. We have not really discussed the Taiwan issue, which seems to remain as an impediment in United States-China relations.

I wonder if we could speculate, perhaps, how could American policy toward Taiwan affect our economic interrelationships with the PRC? Perhaps I will ask Mr. Tallas to start off, since he was the one who raised the issue. If we continue to sell weapons to Taiwan, for example, are there areas of our economic relationships which would suffer and others that would be less likely to suffer as a result of that type of behavior?

Mr. TALLAS. I purposely stayed away from any comment on what particular factors might enter into the nature of our political and diplomatic relations with China. In my comments now, I think I would still like to do that, because I do not think that I have the means to go into the crux of the argument between the U.S. Government and the Chinese Government on the subject.

I think, in addition, it is fruitless to try to debate publicly what it is that we might do or could do and what might be the result, what might be the effect. I am glad you raised the subject again, because as I said before, I think it is pretty clear, at least it is to me, that a deterioration in diplomatic relations with China ultimately will be reflected in our trade relations.

I think if one examines the past 4 years of increased world trade by China, trade with other countries around the world and their actions, there has been a very strong political factor that enters into their foreign trade decisions. I think there are several examples just in the last 12 months.

In addition, I think the nature of the political relationship between our two countries has a great bearing on future prospects for increased trade and investment between our two countries.

Let me just pose a hypothetical, maybe it is not really too hypothetical, an example. We have been talking about the oil exploration and production over a 10- or 20-year period in China. We were talking about \$20 billion in 1981 dollars over the next 10 years as an estimate on the capital cost of that development of production.

It is extremely difficult for the oil companies, for the banks to contemplate that kind of investment principally within the territory of a

country which our Government does not seem to be having very close relationships with. It has not been a large problem to date.

Perhaps some would even argue that trade and investment between our two countries might have even been greater if over the past 6 to 12 months there had not been serious political differences between the two governments.

In the future the depth and breadth of our political relations with China will have a very great and direct bearing on our trade relations.

Senator HAYAKAWA. May I ask this question. At the time we recognized the People's Republic of China we also drew up the Taiwan Relations Act. At that time did the People's Republic of China object to the Taiwan Relations Act?

Mr. SULLIVAN. Yes, they did. They did so very strenuously. They were, however, satisfied by the signing statement that President Carter made, and in fact that was one reason why he made it.

I cannot quote it exactly, but it was to the effect that there was no essential inconsistency between the normalization agreement and the Taiwan Relations Act, that the Congress had wisely given the President great flexibility, and that he intended to use that flexibility so as to insure that the Taiwan Relations Act would be implemented in ways consistent with the normalization agreement.

And on that basis, the objections to the Taiwan Relations Act sort of subsided. What stirred up the issue again with the Chinese and made the Taiwan Relations Act once again an issue was some of the rhetoric that was made in the United States that seemed to put the Taiwan Relations Act and the normalization agreement at odds with one another. Taiwan actually began this, when they called upon the Government of the United States to fully implement the Taiwan Relations Act.

And this became kind of a code word to the Chinese for what does fully implement the Taiwan Relations Act mean? If it means that somehow the previous administration was not implementing it and that anybody who implemented it would thereby be violating the normalization agreement, then maybe we ought to take another look at the Taiwan Relations Act.

And, of course, to say that you are going to implement the Taiwan Relations Act does not really say anything. The next question is how are you going to implement it, because, as President Carter said, it contains a great deal of flexible language. And if the answer is you are going to implement it in a way consistent with the normalization agreement, then there is no issue. If you either do not answer that question or say you are going to implement it in some other way, then it becomes a very big issue indeed.

So I do not think the existence of the Taiwan Relations Act need be an issue in United States-China relations.

Senator HAYAKAWA. Well, the way you describe this, it sounds as though you are saying that President Carter said that some of the terms of the Taiwan Relations Act do not really mean what they say.

Mr. SULLIVAN. No. I think I am saying there is nothing in the Taiwan Relations Act which is necessarily inconsistent with the normalization agreement. Had it been in conflict, I think he probably would have vetoed it. But he did not, because he did not feel there was any contradiction.

Senator HAYAKAWA. Did we not agree to supply defensive arms to Taiwan when they asked for them?

Mr. SULLIVAN. That is right. And when we negotiated the normalization agreement with the Chinese, we said we were going to continue selling defensive arms to Taiwan. So there is no contradiction there. I think the Taiwan Relations Act and the normalization agreement are not in conflict.

Senator HAYAKAWA. But the People's Republic of China is acting as if they were.

Mr. SULLIVAN. No, the Chinese are simply saying, as they said on December 15, 1978, that they do not like our selling arms to Taiwan. They are not saying that we agreed in the normalization agreement not to sell arms to Taiwan. They are saying at the time China agreed to normalization they said they did not like it and thought it was inconsistent with America's recognition of China.

But as the Chinese themselves said, as Premier Hua Guofeng said on December 15, 1978, the Americans insisted they were going to sell arms to Taiwan, and we—China—said we disagree with them but we decided to go ahead with normalization anyway.

So it is an issue between the United States and China, there is no doubt.

Senator HAYAKAWA. It has been an issue since the very beginning then.

Mr. SULLIVAN. Right from the beginning, absolutely. But it was not an obstacle to normalization nor is our selling arms to Taiwan a violation of the normalization agreement.

Senator HAYAKAWA. But the People's Republic of China is acting as though it is.

Mr. SULLIVAN. No. I think what they were saying was that selling something like an F-16 or an F-5G was a violation of their understanding of what the United States was saying at the time of normalization. I think a fair judgment would be to say that they are correct in that.

Senator HAYAKAWA. But did they draw that distinction?

Mr. SULLIVAN. Yes, they did. Very clearly, they have always drawn that distinction.

Senator HAYAKAWA. But they objected to the supplying of spare parts even for obsolete planes.

Mr. SULLIVAN. Well, I think they draw the distinction in this way, Senator: that naturally claiming to be the sole legal Government of China and claiming that Taiwan is one of their provinces, they have to object to anything we do in this area of arms sales.

Now, the next question is when you object, what do you do about it? If the United States was prepared to sell to Taiwan, as indeed they were told both during the normalization discussions and afterward, only "limited quantities of carefully selected defensive arms," and if the United States were going to be "prudent" about what it sold Taiwan, then the Chinese could be satisfied with simply saying you should not be doing this, we are a sovereign nation and this is an infringement of our sovereignty, but we are not going to really let it interfere with our practical relationship with one another.

But if on the other hand the United States were to say it was going to sort of rub the Chinese face in it, as it were, and sell Taiwan weap-

ons that it did not need, which the Chinese know they do not need and which the Chinese know we know they do not need, then the Chinese would start asking the question, well, what is the purpose behind this sale, are the Americans making a political statement? If the Americans are making a political statement, what is that political statement?

Senator HAYAKAWA. I understand the People's Republic of China says that Taiwan does not need these.

Mr. SULLIVAN. But so do the Joint Chiefs of Staff, Senator. That is the point. The Chinese know that we know that Taiwan do not need these.

Senator HAYAKAWA. But I do not know it. That is, Taiwan has planes in the hundreds and the People's Republic of China has planes in the thousands.

Mr. SULLIVAN. I agree, Senator, that there are differences. All I am saying is that the Chinese know that Taiwan does not need these from their standpoint. They know that the Department of Defense and the Joint Chiefs of Staff and President Reagan believe they do not need them. Perhaps they do not know you think Taiwan does need them.

But at any rate, their reaction is that the U.S. Government takes the official position that Taiwan does not need these. Therefore, if the U.S. Government were to insist that it had a "right" to go ahead and sell these, the Chinese would be very concerned that we were therefore making some kind of political statement about the political relationship between Taiwan and the mainland of China which would then make the continuation of political relationships with the United States very difficult indeed for them to maintain.

Senator HAYAKAWA. Thank you.

Mr. WOODARD. Senator, as I recall the normalization agreement, it includes an unusual set of phrases which were stated but each side does not necessarily agree to the statement of the other. So it goes back even further than the Taiwan Relations Act. Essentially the United States states in the normalization agreement that the Taiwan issue shall be settled peacefully, and on the other hand, the People's Republic of China states that Taiwan is a part of the sovereign area of China.

Those two positions are compatible depending upon how one defines the sovereign area of China and peaceful resolution. On the other hand, the way the two governments interpret those clauses is not necessarily compatible. I believe that the origin of that difference goes all the way back to the Shanghai Communique of 1972. The real question really has to do with an unresolved difference over the status of Taiwan.

Senator HAYAKAWA. Thank you very much.

Mr. HOLLAND. Senator, may I quote something from the petroleum regulations to bring it back down to the business approach? I would like to just quote from the regulations as we receive them, and then I will make one other comment. This is article XXVI.

"In case of war, threat of war, or other emergency circumstances, the Government of the PRC shall have the right to requisition a portion or all of the petroleum obtained and/or purchased by the foreign contractor."

Now, that states it pretty tough, and we have to get these things settled. If you, Mr. Tallas, are worried about your loan of \$20 billion to the oil companies, we are worried about being able to pay you if petroleum is requisitioned.

Senator, these emergency circumstances bother us a little bit. We all have to get along. If we are going to go over to China, take leases, and put this money to drill, we have to have some pretty good understandings between China and the United States.

Senator HAYAKAWA. Would you like to make a comment on that, Mr. Lubman?

Mr. TALLAS. Don't quote any articles, please.

Mr. LUBMAN. I will make a comment. These regulations suggest to me that the process of building up a legal framework in which foreign companies can operate in China is going to be a very long one, because when you go to China to negotiate on the contract, you will inevitably be discussing the meaning of these regulations and to what they apply. The contract itself will have problems.

Once again I would just like to stress that even the most innocuous of legal provisions can contain traps, as I am sure you know, and the process of creating a legal infrastructure that is necessary in China is not only going to be conducted in negotiations in Peking; it will be conducted also in negotiations in the field with whoever is representing the new Chinese national offshore oil corporation, with local entities and with other national entities and provincial ones.

I think that you yourself stressed that it will be important to have Chinese speakers involved in the process. They will be building up very slowly, incrementally, a body of experience that is going to help make more certain the environment in which foreign companies operate. We don't know exactly what this means, but the process will be a long one, I think.

Mr. HOLLAND. Yes, thank you.

Mr. SUTTER. Bob Dernberger, you raised your hand earlier. Did you have a remark to make on this?

Mr. DERNBERGER. No, thank you.

Mr. WOODARD. I have a question on the war clause regarding the offshore oil. Isn't it true that the oil supplies in the United States would be subject to requisition during a time of national crisis or war? I would imagine there would be compensation under those circumstances.

Mr. SUTTER. We will open this up now to discussion from the floor. Are there any points people would like to raise at this time?

Ms. BROWN. I am Elaine Brown from the Central Intelligence Agency. I wonder if Mr. Lubman would talk about the domestic economic contracts.

Senator HAYAKAWA. Would you repeat the question, please?

Mr. LUBMAN. The question is whether I will talk about the new economic contract law. The Chinese, as I mentioned this morning, have just adopted a law on contracts between Chinese enterprises. I don't want to talk about it at length because I am not sure that all of us share the same keen interest in it. All I will say is the following:

First, it is not true that until recently China has had no laws. In fact, over the last 30-odd years, the Chinese have been elaborating unsystematically many laws and regulations applicable to the economic activity of state-owned economic enterprises. Many of them are mutually inconsistent. Some of them are secret. The Chinese are now busy systematizing their domestic economic law.

This new law is an initial step in that process, which also includes the drafting of a Civil Code which is now circulating in China, and a Civil Procedure Code. The new law, on the basis of just a brief overview, contains standard rules, terms, and conditions which apply to all contracts among Chinese enterprise and provides for rather legalistic sanctions.

There are penalties for nonperformance. The emphasis is on settling disputes among Chinese enterprises through mediation and arbitration, but it is also possible to go to the local people's courts. The interesting thing about the new law is its detail, its length and the expression of a commitment by the Chinese drafters to create a more readily ascertainable body of law applicable to economic relations among Chinese enterprises.

Mr. SUTTER. Are there any other questions at this time?

Mr. DERNBERGER. The reason I raised my hand earlier was I could not help but sit here thinking that in 1969, Jerry Cohen and I came to this very building arguing and lobbying that a unilateral creation of trade opportunities with China would eventually lead to better political relations with China.

Some of the arguments I heard today seem to be the other way around, that if we promote and create better political relations with China, that is going to facilitate better trade relations with China. I cannot help but be struck by the symmetry. But, the point is do we give economic concessions to gain political objectives as in the beginning, or do we give political concessions to gain economic objectives which appears to be the argument made here.

Mr. LUBMAN. Well, the two sets of issues are locked in a deathly embrace. I don't think there is any doubt about that.

Mr. SULLIVAN. You notice there wasn't much trade before the Shanghai Communiqué.

Mr. DERNBERGER. Well, I would like some specification of the objective function before we settle this. [Laughter.]

Mr. SUTTER. Mr. Woodard in his paper specifies in detail how this works out in our relationship with China.

Are there other questions from the floor?

[No response.]

Mr. SUTTER. Well then, let me introduce the chairman of the Foreign Relations Committee, Senator Percy.

Senator PERCY. I am very happy to join you at the end of this session. I am sorry that I could not arrive sooner. I do want to commend Senator Hayakawa and Senator Glenn as well as Mr. Lin Sloan and Mr. Bob Sutter for developing the concept of this seminar. I know it has been productive.

Let me say that the publication containing the proceedings of the first seminar on the implications of United States-China military relations was an extraordinarily popular edition. It was a bestseller and I am sure this one will be, as well.

I cannot help but think that I partly owe my being in the Senate to two factors, China and the Vietnam war. My former professor at the University of Chicago, professor of economics, Paul Douglas, was the incumbent Senator. We were dear friends and we saw eye to eye on an awful lot of things, but we did not on the Vietnam war and

we did not on the committee that he founded, A Million Americans To Keep Red China out of the U.N.

I have always felt it rather unrealistic in a world organization to keep out a government that controls a quarter of the human race. I have long wanted also to have the world see what I thought was the bitter animosity between the Soviet Union and China and to let them see it right there on the floor of the United Nations as I did as a delegate 7 years ago. But those two things differentiated Paul and me, the past and the future. He was a hawk on Vietnam and I thought it was the wrong war at the wrong time and in the wrong place for us to invest that kind of national energy.

I talked a lot about China during that campaign, and it was a controversial subject at the time. I have long supported the feeling that the Chinese ought to be brought into the world and that it would help a great deal if they were a part of the world organization rather than an outcast. I think that has proven to be a wise policy so long as we do not abandon our friendship, and we shall not, with Taiwan.

We will try to deal with one China, as we have acknowledged that Chinese on both sides of the straits agree. But we will insist that there be a peaceful solution to the problem. It must not be solved by the use of force. That is the main difference that we have with China. We have just gone through another critical period of negotiation or discussion with the Chinese. I am hopeful that the problem can be worked out.

I wish I had been here to hear Greg talk about how to negotiate and do business in China, not just because he is from a great financial institution in my city, Chicago, but also because, when I saw the title of his comments, I couldn't help but think back on my early experiences in doing business with the Chinese.

According to protocol, after the Shanghai communiqué there were five required delegations from the Congress, the Speaker of the House, the majority leader of the Senate, the minority leader, et cetera. The sixth the Chinese themselves picked. And they came over and asked me to be the chairman and to pick the delegation. This was the first one they had had anything to say about.

I asked them why they had picked me? I started naming some people like Senator Javits, who wanted to go, and Senator Pell. I said, "Well, they are obviously senior to me and we go by the seniority system." "Oh, we recognize that," they said, "and you can be the chairman because of seniority." I said, "Why?" They said, "First of all, you helped us get into the U.N., and second of all, you had the longest record of support that we can trace back, support for recognition of mainland China," or China, as they said, "but second," they said, "you also have sought to come into China longer than any other Senator."

They went back to when I had gone to Pakistan and had sought to get into China. I also went to see their Ambassador in New Delhi. I had also gone to Ottawa to their Ambassador, to their purchasing commission, everywhere. They traced my trips. They said, "You have seniority." So I explained to my colleagues that I was chairman and that Jack Javits and Claiborne Pell were vice chairmen.

I tried to negotiate, then, as to where we would go. Tibet was high on my list with that delegation. The President gave us a plane to go

anyplace. Well, they just wouldn't tell me anything about where we would go until we got to Shanghai. Then the itinerary was given to us.

I had wanted to see a prison. Well, I didn't get to see a prison. But after tough bargaining, I finally saw a divorce trial, and I photographed it. I wanted to take my Bell & Howell 16-millimeter camera in. They said absolutely not. A 16-millimeter was prohibited. Why? Because someone had gone in and taken a 16-millimeter film and blown it up to 35, and it was shown someplace, in a theater, I guess. They did not want to take a chance that that would happen again.

So I finally took a sound 8-millimeter camera and had MGM blow it up to 16, and I later showed it to the Chinese Ambassador. [Laughter.]

We have had a couple living with us for 20 years, a couple from China. They are a lovely couple. They have their family back in China. So we took along with us from them a suitcase full of clothes and personal items to be given to their family in China. I negotiated for 2 solid weeks with the Chinese and they would not let me leave that suitcase. I declared it and wanted to pay duty, but "No." I don't know what it was. Tell me why they wouldn't let me leave that suitcase, as the chairman of that delegation.

They could not have treated us more wonderfully. Deng was absolutely gracious, but I could not leave the suitcase. Somehow it might have implied, I finally figured out, that they needed clothing in China. I tried to explain that it was sentiment. Or maybe it was the fact that these two had escaped and they didn't want tainted capitalist clothing. I don't know what it was.

But doing business and negotiating in China is difficult. It is a different culture. We have had to learn a great deal considering we were cut off for 30 years and didn't even know how to handle the protocol of visits in the early days. We have come pretty far but we still have a long way to go.

As a former businessman myself, I know the practical suggestions that you have made in this seminar are most useful.

Senator Hayakawa, I am going to have the first copies that I can get of the proceedings of this seminar sent to the representatives of 300 businesses that I met with in Illinois last Thursday for an all-day session on how to do business abroad and how to open up new markets. All of your remarks and suggestions will be printed there. The subject of China did come up at the conference last week. It just overwhelms business people. Many are afraid to even approach that market.

I do believe that political friendships tend through the centuries to follow trade lanes. Doing business is a very important aspect of our political relationships. Natural ties make us more interdependent, and we should do a great deal more than we are doing now.

I have one or two questions that I would like to ask. Perhaps you have addressed some of these issues already.

To what extent does our Government really assist and help businesses investing or trading in China? Is our Government as responsive as it should be? How do we compare, say, with the Governments of Japan and the European countries in helping our businesses overcome lack of knowledge or lack of understanding of a society from which we have been divorced for so many years? Should the Govern-

ment which Senator Hayakawa and I can influence be doing more to open up trade channels with China?

Mr. TALLAS. If I might comment on that, Senator, I think that of all of the places in the world in which we have Government personnel and where we have trade relations in the past 4 years since 1978, since I have been involved in China trade for my bank, I think without a doubt the facilities for information in China have been excellent. I think that is probably due to the quality of the personnel which we have had in the Embassy in Beijing, and I think the new foreign commercial service and the people who are joining that commercial service in China will mean in the years ahead that assistance will be even better, if that could be possible.

I can only speak from my experience in China, but I think the assistance of the Government to businessmen, at least what I have heard from my customers, has been excellent.

Senator PERCY. I believe that political friendships follow trade lanes and the political climate can affect in one way or another business relationships and opportunities. Can you give us some examples in recent years of how the changing political climate has affected, pro or con, our ability to expand business opportunities in China?

Mr. TALLAS. Well, I think, going back to 1978 and 1979 when the opportunities really opened up to U.S. businesses, it was not a situation where that was the first time an American company has gone to China and had discussions; but it was clear that after 1979 and the reestablishment of diplomatic relations, there was a difference from the period prior and the period subsequent to that, that the propensity for the Chinese parties to enter into negotiations and discussions with American companies was considerably higher. It was almost as if many Chinese agencies were waiting for a signal or a sign from their own Government that would enable them to enter into contractual relations.

In my prepared comments, which I didn't read from this afternoon, I did use a recent example that had been told to me, and that was of a major U.S. company that had been in negotiations for a considerable period of time where in the last stages of that negotiation, all of the substantive issues had been resolved and there were only minor technical points.

This occurred during the period when the Chinese Government and some of their agencies were deferring projects and canceling some large contracts with Japanese companies. At the last moment in these negotiations, when it was already a done deal, suddenly without warning the company was told by the negotiators for the agency in China that a decision had been made to give the contract to a Japanese company that up until that time had not been involved in the particular transaction or bidding for the transaction.

The example I am using is not as applicable as it might be, but I think it does show that there is a very strong political factor involved in China's foreign trade relations. The surmise would be that because of the cancellations of Japanese contracts, this particular ministry decided that it had to provide some favorable action with regard to Japanese companies, and so obviously a political decision was made to award the contract to the Japanese company.

I think there are other examples over the past few years, but it seems clear to me that China seeks a strong political relationship with the United States and as a way of reinforcing that would seek a very strong economic relationship. As others have said, I think the two are inextricably intertwined.

Senator PERCY. Thank you very much.

We have a vote on, but if you have a short comment, I would like to listen to it.

Mr. LARDY. I think the best example is the grain trade. In the sixties the Chinese imported no grain from the United States. But after 1971, when relations between the United States and China began to open up, they began to buy significant quantities from the United States. But the United States was still largely a residual supplier. U.S. grain sales were large only in years when the Chinese could not supply their needs from other sources.

Since 1978, when relations were fully normalized, we have become their major supplier. We have access to this market on a basis that is at least equal to the other major suppliers in the world. So it is quite clear from the 20-some-year history of major Chinese cereal imports that political developments were critical to facilitating U.S. access to the Chinese market.

Senator PERCY. We want to thank all of you very much for being with us. I believe you have a session beginning again tomorrow and there is nothing else for today.

Mr. SUTTER. That is right, Mr. Chairman.

We will reconvene tomorrow morning in this room at 9:30. Thank you all very much.

[Whereupon, at 4:50 p.m., the workshop recessed, to reconvene at 9:30 a.m., the following day, Thursday, February 25, 1982.]

UNITED STATES-CHINA ECONOMIC RELATIONS: A REAPPRAISAL

THURSDAY FEBRUARY 25, 1982

UNITED STATES SENATE,
COMMITTEE ON FOREIGN RELATIONS,
AND THE CONGRESSIONAL RESEARCH SERVICE,
Washington, D.C.

The workshop convened in room 457, Russell Senate Office Building, at 9:35 a.m., Mr. Robert Sutter (member, Congressional Research Service) presiding.

Senator present: Senator Hayakawa.

Mr. SUTTER. I would like to welcome you all to a continuation of our workshop, "United States-China Economic Relations: A Reappraisal."

III. U.S. ECONOMIC POLICY TOWARD CHINA

In the last two sessions—perhaps we should ponder those for a second—we talked about China's prospects and the practical considerations of doing business with China. There was a note of caution in our earlier sessions. We talked of problems in China and problems with American interaction in China. In looking at the prospects, we saw some promising areas, but we also looked at some constraints. We talked to a considerable degree about negotiations and how to be effective in interaction with the Chinese.

We also mentioned briefly the subject that we are going to talk about today, and that is the Government's role. What should U.S. economic policy toward China be? Several issues already have been put forward. One of them is in regard to American income tax and its relationship to taxes charged by China, the notion of more effective Government support for American businesses in the PRC, GSP treatment for Chinese imports into the United States, and a more tolerant American Government attitude toward Chinese imports in general.

Those are some of the issues already before us. There will be many more mentioned today.

Our first paper presenter will be Roger Sullivan. Mr. Sullivan is vice president of the National Council for United States-China Trade. He was a senior staff member of the President's National Security Council before joining the National Council for United States-China Trade. Prior to that, he was a Deputy Assistant Secretary of State for East Asian Affairs, and prior to that he worked in a wide variety of posts in the State Department, including a position as political adviser to the commander in chief of U.S. forces in the Pacific.

Mr. Sullivan.

STATEMENT OF ROGER W. SULLIVAN, NATIONAL COUNCIL FOR
UNITED STATES-CHINA TRADE, WASHINGTON, D.C.

MR. SULLIVAN. Thank you very much, Bob.

I often wondered what it was like to be a Senator sitting here. I find that I am enjoying it already. If it paid better, I might even run. [General laughter.]

I want to outline very quickly three areas in which I think the Government has a role. I would like to begin by recounting a breakfast that we had for the American business community in Beijing last November, which Secretary Regan attended. He was asked a question that we discussed a bit yesterday, which is, what does the Government plan to do to help business. The Japanese Government helps its businessmen, and our Government should help more.

I have heard that question asked of American Government officials so many times before but I thought Secretary Regan's answer was very refreshing. Instead of responding, "yes, we understand, we are not doing very well, and we are going to do better," his response was that "we are not going to do your job for you, we are going to remove the constraints under which you operate, but it is up to you to do the job yourself." I think that is a challenge that the American business community is willing to accept.

As I mentioned yesterday, there are a number of areas in which we certainly hope the U.S. Government would be willing to take the handcuffs off not only the American business community but itself as well. In some cases, the types of things that I am talking about perhaps do no real harm to the United States-China economic relationship, but they certainly sour the atmosphere.

In the second area, the trade agreement that went into effect in 1980 specified that the two Governments have an obligation to create favorable conditions for strengthening trade relations in all aspects of their relationship. This area then involves negotiation of agreements and other actions which can only be performed on a Government-to-Government level.

The third area where the Government can help is in the creation and maintenance of a favorable political climate for the conduct of those economic relations. On the removal of obstacles, I think a great deal already has been done, but it is, after all, 10 years after the Shanghai Communiqué, 3 years after the normalization of diplomatic relations, and 2 years after the signing of the trade agreement and the date it went into effect, yet we still have not completed the process of normalization of our economic and trade relations.

Last year the administration said it would seek the approval of the Congress for a number of measures that would "separate China from legislation adopted against Communist countries over the years," but I note it has not taken action on that yet. I realize they may feel there is no sense of urgency since the effect of removing these, as I said, is going to be largely symbolic, but they are important nonetheless.

There are five laws that I would say need changing: The Foreign Assistance Act, which prohibits assistance to Communist countries, including China; Public Law 480, the Agricultural Trade and Development Act; the Export-Import Act; the Trade Act of 1976; and the Trade Agreement Extension Act of 1951.

I am not advocating, in proposing changes in the Foreign Assistance Act, a massive aid program for China, but what I am advocating is that the Government give itself the flexibility necessary to act in modest and selective ways as our economic interests might dictate. On export-import loans, there is an annual waiver requirement. There is also a special national interest determination requirement which has to be made by the President and reported to the Congress for any transaction over \$50 million. I think this injects an unnecessary element of uncertainty, and I think it should be removed.

Public Law 480 restricts sales to friendly countries, defined as not dominated or controlled by a government or organization controlling a world Communist movement, a definition which for purposes of implementation has put China in the Soviet bloc. Ironically, China was declared a friendly nation for purposes of reimbursable assistance when Vice President Mondale went to China, but for some reason it is not a friendly nation for other purposes.

The Trade Act of 1974, the Jackson-Vanick amendment, requires an annual waiver. I would suggest at a minimum that that be changed to a multiyear waiver, again to lend a greater sense of continuity and a more stable environment for economic relations.

The Trade Agreement Extension Act of 1951 can only be described as a 1950's anachronism, but it is still on the books. It was introduced by Senator McCarthy, as my mother used to say, not the nice one but the other one. [General laughter.]

Intended as a slap in the face, it prohibits the importation from China of seven types of furs, what some wag termed the "Seven Deadly Skins." [General laughter.]

The other major area is the area of export control. Certainly the business community has welcomed a number of important steps the administration has taken to liberalize controls and to streamline the procedures for which the Commerce Department deserves full credit.

It is too bad I don't see a Senator here this morning. I was going to put in a pitch for some more money for the Commerce Department so they could get a decent computer system which would enable them to process what are called carbon copy licenses, in other words, license applications for something they have already granted, without having to go through a long delay.

But the liberalization of the export control regulations really does not do the job. I think a number of people in the administration are coming to that same conclusion. The reason why it does not do the job is that it attempts to apply a technical remedy to what is a policy problem. The ambivalence of the policy problem, the ambivalence of the regulations is nowhere more evident than in the guidelines the Commerce Department put out in December.

At one point the regulations state that it is the policy of the United States to regard China as a friendly country, and that "It is in our national interest to foster a strong, secure, and friendly China capable of deterring potential aggressors." And then you turn the page and it says that these new guidelines for China are consistent with the policy "to restrict the export of goods and technology which would make a significant contribution to the military potential of a country which could prove detrimental to the security of the United States."

Not surprisingly, there is great confusion in the bureaucracy as to what their marching orders are. This confusion is particularly strong in the Department of Defense, because the Export Administration Act of 1979 provides that the Secretary of Defense must recommend disapproval of any license application if it is going to strengthen the military potential of any country exports to which are controlled for national security reasons. And China is in that category.

What makes the Defense Department even more nervous is that they know the President has all the authority he needs in the law to change that. The law not only gives him the flexibility, but it encourages him to review this listing of countries. Even in the case of Communist countries it enjoins against determining the policy exclusively on the basis of the country's Communist status, but rather urges the President "to take into account such factors as the country's present and potential relationship to the United States, its present and potential relationship to countries friendly and hostile to the United States, and other factors deemed relevant by the President."

I think that it is quite clear that the President not only has the authority to do this, but should move in this direction. Why the administration has not moved is a question you can ask as well as I. I would think one reason may be that there is doubt or a question in the administration's mind as to what the attitude of the Congress would be. I would certainly hope that the Congress would support a move in that direction. But in any case, I think our policy needs to be clarified, and I would specifically propose that the Congress ask the GAO to review the export administration system as it is applied to China and then the Congress could make its recommendations to the executive branch.

On what can be done on the Government-to-Government basis, in my paper I did not mention the tax treaty. I fully support the idea of the tax treaty. I did not mention it only because I thought it was already being pursued, and because the short-term problem which the oil companies face is in hand because of the actions being taken by the Treasury Department.

I think we could also benefit by an investment treaty, and I would also urge the Government to press the Chinese in the area of protection of patents and copyrights, industrial property. The Chinese have not acted in this area, and it is essential that they do so.

Do I have a few more minutes?

Mr. SUTTER. Two or three.

Mr. SULLIVAN. Well, I think perhaps most important of all is the final point that the Government's most important responsibility is to maintain a close and friendly bilateral political relationship. I am suspicious of rules of thumb about China. Most of them are wrong, and some of the more popular ones, are dangerously wrong. One of these is that China needs us more than we need them. Worse still is the view that if we work to maintain a healthy strategic relationship, the bilateral relationship will take care of itself.

Actually, it is just the opposite. The rule of thumb that I think I would accept, and one which I have seen in operation over the last 10 years, is that as long as our bilateral political relationship is sound, and the Taiwan issue, of course, dominates that, the other aspects of

the relationship, both strategic and economic, will not only be healthy but will reinforce each other. When the Taiwan issue is mismanaged on either side, so that it becomes an active stumbling block, everything else in the relationship seems to suffer.

Senator Glenn yesterday mentioned that on his recent trip to China, he had wanted to talk to the Chinese about important issues, and found that they kept coming back to the Taiwan issue. That was the experience we had all had in working with China. The first time that changed was on the Mondale trip, by which time the Taiwan issue had been put on the shelf effectively, and therefore the issue of Taiwan and the bilateral relationship hardly came up.

As someone mentioned yesterday, we have seen this principle work in the 1975-76 trade situation. The China Council of the Asia Society noted in a pamphlet they published at normalization in 1979 that United States-China trade fell sharply in the 1975-76 period, and grain purchases halted completely because of Chinese dissatisfaction with the pace of normalization; that is, the Taiwan issue again.

In the past year we have seen the strategic relationship with China instead of reinforcing and being reinforced by the bilateral political relationship work against it. It is now stalled. The Taiwan issue cannot be solved, at least not in the short term, and certainly not by the United States, but it can be managed, and I think the administration has demonstrated in the last 6 months that it can be managed without serious damage to our economic relationship, and without damage to the interests that we want to protect with the people of Taiwan.

Thank you very much.

[Mr. Sullivan's prepared statement follows:]

PREPARED STATEMENT OF ROGER W. SULLIVAN

PROMOTING UNITED STATES-CHINA TIES—WHAT SHOULD GOVERNMENT DO?

Article I of the Trade Agreement between the United States and the People's Republic of China provides that both sides should "undertake to adopt all appropriate measures to create the most favorable conditions for strengthening, in all aspects, economic and trade relations between the two countries so as to promote the continuous, long-term development of trade between the two countries." It is particularly appropriate, a few days before the tenth anniversary of the Shanghai Communique to examine what steps still remain to be taken before we can claim to have accomplished our goal of full normalization of economic relations with China.

What does business want, and what does business have a right to ask from government? During his visit to Beijing last November where he co-chaired the 1981 session for the United States-China Joint Economic Commission meeting, Treasury Secretary Donald Regan told the resident American business community there that the Reagan Administration is committed to eliminating unnecessary regulations that hamper the ability of Americans to conduct business abroad. But once the handcuffs are removed, it will be up to the businessmen to do the job; government cannot do it for them.

The overwhelming majority of U.S. businessmen welcome that challenge. They also acknowledge that much has already been done to remove the disincentives and obstacles that once stood in the way of companies trying to compete effectively abroad. But more needs to be done. Businessmen also ask government to take responsibility for the actions necessary for those "favorable conditions" referred to in the trade agreement which can only be achieved on a government to government basis. Over 3 years after the normalization of diplomatic relations with China and 2 years after the trade agreement went into effect, we still have not created the "most favorable conditions" for strengthening our economic relations with China, and unnecessary legal impediments to trade with China still remain.

In the category of handcuffs that should be removed, I think our requests are modest. Basically they call for an end to treating China, in legislation as well as in practice, as if it were a member of the Soviet bloc or the Warsaw Pact. We understand this to be the policy of the current administration. Significant steps have been taken to liberalize the control of exports to China, and in June of last year a senior official of the Administration said that it would "seek the approval of the Congress for a number of measures that would separate China from legislation adopted against Communist countries over the years." Action to do so, however, has yet to be taken.

One reason for delay may be that there seems to be no need for urgency. It is difficult to quantify the effects of removing this legislative baggage of the past, although I believe all would concede that to the extent the effect can be measured it is negative. Underestimated, in my view, is the symbolic effect of leaving outdated legislation in effect—the deleterious effect it has on the atmosphere and the confusing signals this sends to all concerned, Chinese as well as Americans, as to the intent of the Congress as well as the Executive Branch in the conduct of our relations with China.

There are five laws that need to be changed: the Foreign Assistance Act, the Agricultural Trade and Development Act (PL-480), the Export-Import Bank Act, the Trade Act of 1976, and the Trade Extension Act of 1951. The overall objective in modifying these laws is to establish a fully normal and competitive economic relationship with the PRC that will provide for long-term opportunity and stability for American business development in China. By clarifying the ambiguities in these laws, both company executives and government officials will have clear evidence that the policy of normalizing our economic relations with China has the full support of the Congress.

The specific effects of modifying these laws will be (a) to separate China in law, as it is in fact from the Soviet Bloc; (b) to characterize the PRC properly as a developing nation, with its particular needs and problems acknowledged; and (c) to remove remaining direct and indirect impediments to American firms carrying out business with China.

Foreign Assistance Act of 1961

The Foreign Assistance Act prohibits aid to the PRC. Section 620(b) of the Act states that development assistance cannot be provided to any country "unless the President determines that such country is not dominated or controlled by the international Communist movement." Section 620(f) specifically refers to China.

The President can waive Section 620(f), but only if he determines that (a) assistance is vital to U.S. security interests (b) the beneficiary is not controlled by the "international Communist conspiracy," and (c) the assistance will further promote the independence of the recipient from "international Communism." To require the President to act alone without support from Congress is not reasonable and would tend to perpetuate the impression that there is a policy difference between the legislative and executive branches.

During these days of budget stringency, no one would seriously propose that Congress approve an aid program for China. That is not the issue. The Government, however, while it is removing the regulatory handcuffs from the business community, should remove the cuffs that bind its own hands and limit its flexibility. As China develops we may find it in our interest to fund a modest program of trading or feasibility studies to protect the competitive position of U.S. exporters.

The Export-Import Bank Act of 1945

The Export-Import Bank Act requires that no loans and transactions for sales or leases to Communist countries can be permitted unless the President determines that they are in the national interest. This determination for China has already been made (PD 85-15, April 2, 1980).

A general waiver making Eximbank financing available for the PRC has been made under the terms of the Trade Act of 1974.

However, under Section 402 of the Trade Act, Eximbank facilities for sales to the PRC are still subject to an annual waiver, injecting an unnecessary element of uncertainty in the development of long-term trade relations with China. Technology contracts not only often take many months, or even years to complete, but also take many years to fulfill.

In addition, a special national interest determination must be obtained from the President and reported to Congress for any transaction over \$50 million.

All major United States sales to the PRC are likely to involve Eximbank financing. Indeed, if they do not, the financing is likely to be sought elsewhere, the equipment sourced elsewhere and the jobs exported. Some 85 percent of Japanese plant sales to the PRC have involved Japanese Eximbank credits.

China should also be removed from the national interest determination requirement for projects over \$50 million.

The Agricultural Trade Development and Assistance Act of 1954 (Public Law 480)

This Act restricts concessional sales of (Title I) agricultural commodities and food assistance (Title II) to "friendly countries." These countries are defined in Sections 103(d) and 103(j) as those not dominated or controlled by a government or organization controlling a world Communist movement, a definition that has placed the PRC in the Soviet Bloc for purposes of implementation.

Last year, China received some Title II U.S. agricultural products indirectly under provisions of the Act allowing shipments of commodities to countries such as the PRC via multilateral organizations.

Title I concessional food aid to China, however, is prohibited under the terms of the Act.

China is already a major commercial market for U.S. agricultural products. It is therefore not vital that Public Law 480 be available for China. Once again, however, there is symbolic value in changing the law. Also it is my understanding that the Department of Agriculture would welcome the increased flexibility a change in the law would give them.

The Trade Act of 1974 (Public Law 93-618)

The Jackson-Vanik freedom-of-emigration amendment, Section 402 of the U.S. Trade Act of 1974, was aimed primarily at the Soviet Union. But in doing so it lumps all the non-market nations together, thus putting China in the same category as the Soviet Union.

The complex provisions of Sections 402 and 405 of the Act serve as unnecessary obstacles to trade with the PRC. Importers and exporters are affected by the requirements that the President must review China's emigration practices annually in order to allow China to continue to receive Most Favored Nation tariff treatment, U.S. Government credits and credit and investment guarantees.

The annual waiver requirement results in uncertainty among U.S. companies doing business with China as to the continuation of MFN from year to year. Importers normally conclude contracts for purchases from China from 6 to 18 months in advance of delivery of the goods.

A U.S. company negotiating a countertrade or compensation agreement whereby American technology, equipment or products are paid back with Chinese products or raw materials over a period of years is faced with an even more serious dilemma. American joint ventures in China designed to export products back to the U.S. market also face the uncertainty posed by the provisions of the Trade Act.

A multi-year waiver for 3 or 5 years for the PRC would lend more continuity and ensure a more stable environment for the growth of Sino-United States trade.

The Trade Agreements Extension Act of 1951 (the seven deadly skins)

Thirty years ago, on June 16, 1951, during the Korean war, Congress passed this Act prohibiting the importation from China (and the Soviet Union) of the "seven deadly skins"—ermine, fox, kolinsky, marten, mink, muskrat, weasel furs and skins, dressed or undressed. The amendment was introduced by Senator McCarthy.

China is the only trading partner of the U.S. with most-favored-nation tariff status to which such a unilateral trade restriction applies. This anachronistic law, still on the books, should be repealed. Clearly it acts as a direct impediment to trade in furs, a growing category of imports both from the world as a whole and from the PRC.

Export control

In the licensing of so-called dual-use technology products and technology for sale to China under the Export Administration Act of 1979, considerable progress has been made both in shortening the processing time for license applications and in liberalizing the technical standards for issuing licenses. Under the guidelines published by the Department of Commerce in the Federal Register at the end

of December 1981, the new rule of thumb is that there will be presumption of approval for items at a technical level double that previously approvable for China and case by case consideration of items over that level. Officials in the Executive Branch responsible for administering the export licensing system now say that they believe the process of liberalization has gone as far as it can in the absence of a decision to remove China from the category of countries exports to which must be controlled for national security reasons.

Welcome as these steps toward liberalization and streamlining of the system have been to the business community, there is a growing realization both within the government and in the business community that liberalization does not really do the job. It fails because it attempts to use technical remedies to resolve a policy issue. What results is confusion among the bureaucrats who must administer the regulations as to precisely what the policy is. Nowhere is this policy ambiguity better illustrated than in the new guidelines just issued by the Commerce Department. On the one hand they state that it is the policy of the United States to regard China as a friendly country and that "it is in our national interest to foster a strong, secure and friendly China capable of deterring potential aggressors." The same document states that the new guidelines are consistent with the policy "to restrict the export of goods and technology which would make a significant contribution to the military potential of any other country or combination of countries which would prove detrimental to the security of the United States."

Those in the Executive Branch charged with implementing these regulations, particular officials in the Department of Defense which has special responsibilities under the Export Administration Act, confess to being confused by what they see as conflicting marching orders. Defense Department officials are aware that the law (Section 10 G1 of the Export Administration Act of 1979) requires that the Secretary of Defense recommend disapproval of any proposed export "to any country to which exports are controlled for national security reasons" whenever the Secretary determines that such export would "make a significant contribution, which would prove detrimental to the security of the United States, to the military potential of any such country." In other words, as the Defense Department interprets this provision of the law, any significant improvement in China's military potential is by definition contrary to U.S. national interests. They frankly admit that they cannot reconcile this interpretation with the apparent changes in the United States-China relationship and in U.S. policy, but until someone clarifies their instructions, they intend to be very cautious about approving licenses for export to China.

They are confused also because they are aware the Executive has ample discretion under the law to remove China from the category of countries exports to which must be controlled for national security reasons and to treat it like India or Yugoslavia. Indeed, the law encourages review and updating. In the case of Communist countries, the law specifically enjoins against determining policy exclusively on the basis of its Communist status and urges the Executive "to take into account such factors as the country's present and potential relationship to the United States, its present and potential relationship to countries friendly and hostile to the United States, and other factors deemed relevant by the President."

Since deregulation of business and liberalization of the export licensing system as applied to China are key administration policies, why has the Executive not removed China from this national security category? A major reason may well be concern that such a change might incur opposition in the Congress. I would hope not, but in any case, if there is doubt as to the attitude of the Congress on this issue, it should be clarified. Members of the Congress may therefore wish to consider asking the General Accounting Office (GAO) to review the implementation of the Export Administration Act as it applies to China. On the basis of the GAO report, I would hope the Congress would encourage and urge the Executive Branch to move in the direction it seems to want to go anyway.

If there is a problem with baggage of the past, there is also an accumulating economic agenda to be addressed on a government-to-government basis. This agenda is vital for the facilitation of newly developing business and services with the Chinese. It includes the following:

(a) *Industrial Property*.—The U.S. Government should ensure that adequate patent protection will be afforded U.S. products and technology in China. The Trade Agreement with China states (Article VI (1)), that both sides "recognize the importance of effective protection of patents, trademarks and copyrights."

Each party "shall seek to ensure to . . . persons of the other Party of patents and trademarks equivalent to the patent and trademark protection correspondingly accorded by the other party." (Article VI (3)). The two countries also agree to provide means, in accordance with their "respective laws, to restrict unfair competition involving unauthorized rights." (Article VI (4)).

From reports of recent meetings with the Chinese Patent Office we understand China's patent law, now in draft, will be issued sometime in 1982 following approval by the People's Congress. (The law will contain 100 articles in six chapters covering general principles, inventions, utility models, industrial designs, and litigations.) But patents will not be available for inventions for food, flavorings, pharmaceuticals, some chemical substances, nuclear fission, medical diagnostics, and computer software. All these are among the categories with strong sales potential to the PRC.

The Chinese patent law has not yet been published, the Chinese are not contemplating joining the Paris Convention until at least 1985, and there is no copyright law yet in China. Under the circumstances it is essential that the U.S. Government make known to the Chinese the concerns of American companies and publishers about the lack of patent protection, the apparent omission of major product categories in the proposed patent law, and present lack of copyright protection in China.

(b) *Bilateral Investment Treaty*.—The concept of bilateral investment treaties is relatively new to the United States. Such treaties provide a broad legal framework for investment in a country, with provisions for dispute settlement, expropriation, industrial property rights, finances, and national treatment. Such a treaty would go well beyond the scope and coverage of the present OPIC agreement with China which is primarily insurance coverage against expropriation and war.

The broader protection of an investment treaty with the Chinese would encourage American companies to participate in Chinese ventures over the long-term and create a much more favorable environment than now exists.

(c) *Shipping*.—Our trade agreement with China provides for both sides to "make every effort . . . to contribute . . . to attaining the harmonious development of such (bilateral) trade." (Article 1 (2)). While there has been admirable progress in the effort to create harmony, such as at the meetings in Washington and Beijing of the Joint Economic Commission, there is one area in which there is distinct lack of harmony—that of shipping.

We have a maritime as well as trade agreement with China, but despite both, serious problems remain. Among these are:

China is counting the volume of U.S.-bound goods transported by PRC-controlled, Hong Kong-registered feeder vessels to Hong Kong in the third country portion called for under our bilateral maritime agreement;

the Chinese persist in levying shippers for container stuffing charges (normally paid for by the sellers);

and their fees for feeder services to Hong Kong are 2 to 3 times higher than normal feeder services. As a result, American shippers have to charge a "container usage fee" to American importers to cover the additional costs.

These practices go against the spirit and language of the trade agreement. The U.S. Government should continue to make clear the position of American companies and to closely monitor these kinds of practices.

(d) *Nuclear energy*.—With the decision of the Chinese to move ahead on long-term development of nuclear power for energy generation, the U.S. Government should negotiate a bilateral nuclear regulatory agreement with China to pave the way for use of American nuclear technology in the PRC. I understand that exchanges are already underway in this area.

Conclusion

It is only ten years since the Shanghai Communique. In that short time trade has risen from zero to about \$5.5 billion last year, for an accumulated total over the decade of \$16.77 billion of which over \$12 billion was U.S. exports to the PRC. China is already our third largest market in Asia. More impressive even than the figures is the extent and variety of economic activity other than trade including investment, licensing and compensation trade. The Chinese Government has just announced it will begin at the end of March to elicit bids for its offshore oil concessions. Major American oil companies will, by the end of this year or early next, begin an investment that could reach \$3 billion by 1985 and over \$20 billion by the 1990's.

The benefits of all this activity not only to our two countries but to the region and the world as a whole are obvious. Significant also, however, is that the pace of change in our economic relations with China is increasing rapidly. As the relationship broadens and deepens, and the competition with other countries sharpens, these once merely annoying obstacles placed in the way of doing business with China become serious and onerous constraints on our ability to export in an increasingly competitive world. Ten years is a short time in one way, but it should have been long enough to have completed the basic task of full normalization of our economic relations with China. There are so many real difficulties we face as a nation.

We should not have to waste efforts coping with the baggage of the past.

Mr. SUTTER. Thank you very much, Mr. Sullivan.

Our next speaker is David Denny. David Denny is currently international trade specialist, Office of Chinese Affairs in the Department of Commerce. He has served for 2 years in the U.S. Embassy in Beijing as commercial attaché. He was educated and has a Ph. D. in economics from the University of Michigan, and has taught courses on Chinese economy at the University of Maryland and at the Johns Hopkins University School of Advanced International Studies.

Mr. Denny, please.

**STATEMENT OF DAVID L. DENNY, OFFICE OF CHINESE AFFAIRS,
BUREAU OF EAST-WEST TRADE, DEPARTMENT OF COMMERCE**

Mr. DENNY. Thank you, Bob.

Before I begin talking about some of the policy issues that will confront us in the future, let me draw on my paper to make two points that came out of yesterday's discussion. First, we spent a good deal of time yesterday discussing the problems and potential of United States-China trade. I think it is important to emphasize that although China is not close to becoming one of our most important markets or sources of supply, nevertheless China already is an important trade partner of the United States.

In 1980 and 1981, China ranked among our 15 most important export markets in the world. It was our fifth largest Asian market. In these 2 years, China accounted for nearly as many exports as all of the countries in the Soviet bloc combined. For some products, China has become one of our most important markets. In 1981, China bought 16 percent of the wheat that the United States sold on the world market. The percentages for other commodities are as follows: Raw cotton, 20 percent; manmade fiber, 31 percent; lumber, pulp, and paper products, 3 percent.

The fact remains that China takes only a little over 1 percent of total U.S. exports. The majority are concentrated in agricultural and industrial raw materials. China takes less than one-half of 1 percent of American worldwide machinery and equipment exports. With the single exception of oil-drilling equipment, China cannot be considered a major market for U.S. machinery and equipment. As a market for U.S. exports, China ranks far behind our largest export markets in Japan, Europe, and North America. It would require continued spectacular rates of growth for some time to change that situation. As Professor Dernberger and Professor Lardy made clear yesterday, China's many economic problems make that kind of success very unlikely.

The second question that I would like to pursue briefly is the degree of support and enthusiasm of Chinese middle-level officials for present trade policies and trade reforms. This obviously is a very key question. To what degree do they share the "bureaucratic paralysis" and "unwillingness of cadres to do anything at all" that Lyman Miller so correctly warned us about yesterday? I do not wish to minimize these problems, but on the other hand, the past few years have produced a situation in which it seems that most important Chinese economic organizations are very interested in making a substantial commitment to foreign trade. Yesterday, the word "aggressive" was often used to describe China's foreign trade organizations and I think that is an accurate description.

Let me cite just one kind of example. I have been studying the new trend toward setting up spare parts warehouses, training, and repair centers for foreign goods in China. One of the striking themes that emerges from this new trend is that many Chinese organizations have concluded that it is in their interest to sign multiyear contracts to represent foreign companies in China or to facilitate the foreigners' desire to do it themselves.

Clearly, many Chinese organizations are primarily trying to find new roles to play as they face orders to phase themselves out of older responsibilities. Nevertheless, even though they are driven by diverse motives to find new responsibilities to justify their existence, what is interesting to me is that so many Chinese organizations are seeking a foreign connection to attain that goal.

Let me turn now to a discussion of some of the more mundane policy issues that I think already are confronting us and will in the future. I apologize for covering much of the same ground as Roger Sullivan, and I think most of my themes will be pretty much the same.

First is business facilitation. Because of basic differences in our two societies, it will never be possible to achieve exact equality of treatment on all issues. In fact, in some areas of business facilitation, it is the Chinese who are able to provide us with better treatment than we can offer them. However, in general, our business people are disadvantaged because of basic differences between an open and a closed society.

Most simply, the Chinese have found that they can achieve their purposes by dealing with whichever private institution or even level of government that will be most enthusiastic about responding to their requests. Even though Chinese society is far from that monolithic institution it once was, it is still a great deal more centralized and disciplined than our own.

In the last 2 years, progress has been made on obtaining better treatment for U.S. business persons operating in China on visa questions, domestic travel within China, more uniform implementation of Chinese custom, laws, and informal assurances on office facilities. These are terribly nitty-gritty, nonglorious type policy issues to keep hammering away at. Unfortunately, unless we are serious about getting some measure of reciprocity for our business representatives and are willing to back up this goal by withholding amenities for their operations in the United States, there will be less progress than there could be and should be.

Briefly, on export controls, as Roger said, we have announced a significant liberalization in our export control policy toward China,

and we have streamlined the mechanism for approving applications. There already have been significant positive results. Nevertheless, with some justification, both Chinese officials and U.S. business people think the implementation has not been as rapid as it should have been. Some business people continue to feel that the treatment of their export applications is inconsistent with stated policy. Our task for the immediate future will be to try to make sure that all agencies treat Chinese cases in consonance with President Reagan's policy.

Next let me discuss legislative changes. There are a number of laws that still discriminate against China to the detriment of United States commercial interests. We embargo the "Seven Deadly Skins," and as Roger said, our legislation prevents giving economic aid to China. I agree with Roger that the primary effect of changing these laws would be to bring our legislation into line with the realities of current China policy and the present situation. We should not expect significant changes in the level of trade from such changes.

The United States is strongly opposed to tying foreign assistance funds to particular commercial projects. Speaking strictly for myself, however, I believe that some consideration should be given to the commercial implications of foreign assistance. With only a small amount of money to work with in China, there will be many attractive alternatives from which to choose. I believe that there will be many projects which are fully defensible on their own merits, and which, while not conditioned on or directly related to U.S. commercial interests, would nevertheless be supportive of these interests.

Let me give you an example off the top of my head. Suppose that the Chinese intend to place some of their South China Sea oil exploration support activities on the very poor and underdeveloped island of Hainan. A project to improve the transportation and communications facilities might be fully defensible on traditional grounds, but also would have the advantage of facilitating an important U.S. economic interest.

Finally, let me mention another very important issue that has come up before, industrial property protection. Present Chinese economic strategy is to downplay buying complete industrial facilities in favor of purchasing technology and selected pieces of equipment to upgrade existing facilities. Moreover, Chinese organizations are under intense pressure to earn foreign exchange and will certainly wish to export commodities made with imported technology.

Moreover, there is still a substantial bias in China in favor of depending on their domestic science and technology to provide most of the inventions and innovations needed by China's industries. In the United States-China trade agreement, China is committed to establishing a patent system that would go a long way toward reassuring U.S. firms about Chinese adherence to basic international standards. However, the adoption and implementation of this new system has been delayed. Inevitably, rumors are circulating that part of the problem has to do with divisions among the Chinese leadership about how far China should go in adopting international standards.

Unless China does make progress in this area, it is very clear that issues in this area are going to become increasingly contentious in the near future.

Thank you.

[Mr. Denny's prepared statement follows:]

PREPARED STATEMENT OF DAVID L. DENNY¹

UNITED STATES-CHINA TRADE: RECENT TRENDS, FUTURE PROSPECTS, AND POLICY ISSUES

Before turning to a discussion of our present and future economic policies toward China, I will begin with a discussion of the political and economic contexts for these policies.

I will leave the larger questions of China's future foreign policies and the question of United States-China bilateral relations to others. However, the following discussion of our commercial policy toward China should be understood in the context of our current general policy toward China—which, I think, can be succinctly summarized as that toward a friend but not an ally.

Let me turn immediately to a discussion of the economic context for our commercial policies toward China. The next two sections describe recent trends in United States-China trade and the future prospects for China's foreign trade.

United States-China trade: Recent trends

In the decade following the resumption of commercial relations, United States-China trade has grown from insignificant levels in the early 1970's to a position where China has become an important market for U.S. goods and technology. China already ranks among our 20 most important export markets, was our fifth largest Asian market, and in 1980 and 1981, accounted for nearly as many U.S. exports as all of the countries in the Soviet Bloc combined. For some products, China has become one of our most important markets.

Because of the much smaller size of China's total trade, the United States has already become China's third largest trading partner. The U.S. share of Chinese worldwide imports has held fairly steady at just under 20 percent for the last 2 years. Chinese exports to the United States have continued to expand rapidly. In 1980, the U.S. market took more than 5 percent of China's total exports and the 1981 share will be considerably higher.

United States-China trade in 1981 totaled \$5.5 billion composed of \$3.6 billion U.S. exports and \$1.9 billion U.S. imports. The trade surplus declined—primarily because of continued rapid growth of Chinese exports. Nevertheless, there still is a healthy surplus of \$1.7 billion.

The growth in United States-China trade in the past few years came about partially as a result of a shift in China's import demands towards agricultural products (wheat, cotton, soybeans and corn) and industrial raw materials (man-made fibre, iron and steel products and lumber and paper products). Moreover, there was a moderate upward shift in the U.S. share of the Chinese market for machinery imports.

By the early 1980's, China had become the fifth largest Asian market for U.S. products. Exports to China were far behind those to Japan and Saudi Arabia but were comparable to those to Taiwan (\$4.3 billion), Korea (\$5.1 billion) and Singapore (\$3.0 billion) and far exceeded U.S. exports to India (\$1.7 billion), the Philippines (\$1.8 billion) and Malaysia (\$1.5 billion).

The United States had become China's second most important supplier by the early 1980's. In 1980, the United States had nearly 20 percent of the "China market" and the U.S. share slipped only slightly in 1981. For a few products, China is already one of our most important markets. In 1981, China bought 16 percent of our wheat that the U.S. sold on the world market. The percentages for other commodities follows: raw cotton (20 percent), man-made fibre (31 percent), lumber, pulp and paper products (3 percent).

U.S. machinery and manufactured exports to China have also grown but the trend has been erratic and is not nearly as impressive as for agricultural products. Nevertheless, by 1979, the United States was China's third largest supplier of machinery and manufactured products (far behind Japan and West Germany). In 1979 and 1980, the United States sold over \$500 million and \$800 million worth of machinery and manufactured products and gained about 7 percent of this market. Partial figures for 1981 indicate that our sale of manufactured products and machinery will be down somewhat as will our market share.

China has become an interesting and reasonably consistent market for some U.S. equipment such as computers, other scientific equipment and measuring, testing and control equipment. However, with the possible exception of oil drilling

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equipment, U.S. machinery sales to China have seldom exceeded 1 percent of total worldwide sales. From 1977 through 1980, the United States sold China a total of \$330 million worth of oil drilling equipment—equivalent to about 4 percent of total U.S. worldwide exports of this equipment. In 1981, sales to China declined to \$44 million (less than 1 percent of total U.S. worldwide sales) reflecting a decline in China's on-land drilling activity. These figures, of course, may rebound once China begins its offshore oil exploration program.

The fact remains that China takes only a little over 1 percent of total U.S. exports and the majority are concentrated in agricultural and industrial raw material products. China takes less than one-half of 1 percent of American worldwide machinery and equipment exports. With few exceptions, China cannot be considered a major market for U.S. products. As a market for U.S. exports, China ranks far behind our largest export markets in Japan, Europe and North America and it would require continued spectacular rates of growth for some time to change that situation. U.S. imports from China are even smaller but their growth has been much more consistent and they have continued to register spectacular growth rates in the last 2 years (79 percent and 73 percent respectively). In some particular categories—most notably textiles—China has become one of our most important foreign suppliers. Of equal importance, the United States takes a significant share of some Chinese export commodities such as clothing. In 1981, we purchased 8 percent of China's total clothing exports—commodities for which the Chinese would find it difficult to find alternate markets.

The trade figures themselves, of course, only tell part of the story. One of the most interesting developments in China's foreign trade in recent years is the Chinese willingness to enter into agreements that go beyond simple purchase and sales of commodities, equipment and even complete plants. Now the Chinese economy is open for a far more broad and long-term range of foreign involvements. The most known activities involve joint ventures, cooperation with foreign enterprises to develop China's natural resources and special economic zones which will allow the duty free import of equipment and materials to produce products for export. These developments, however, are only the most striking aspects of a program that has led 70 or more U.S. firms to establish permanent offices in China. Many U.S. firms have concluded that the long-term market is interesting enough to establish spare parts, training and repair centers to service the equipment they have already sold or expect to sell in the future. Companies producing products as varied as offshore drilling rigs (Baker Marine, Bethlehem Steel and Litton Industries), aircraft doors (McDonnell Douglas), running shoes (Nike), containers (CTI), sporting goods (AMF), ceiling fans and numerous textile products now have multi-year (normally 5 to 10 years) contracts to send their equipment, technology and engineers to China to produce products for the United States or world market.

This growing interest in the United States-China commercial relationship has brought in its wake lawyers, accountants, bankers, consulting companies, business management specialists and advertising specialists. All have, in one way or another, been able to establish offices in China, to develop various kinds of relationships with Chinese counterparts and to actively advise their American clients.

Another key aspect of our developing relationship with China is the transfer of technology. A large part of this transfer is occurring through the exchanges of students (the Chinese currently have 6,000 students in this country, about half of whom are sent by the Chinese Government), scientists and educators. Naturally, the private sector and the U.S. Government hope and anticipate that these exchange programs and our growing commercial relationship with China will also produce a demand for U.S. proprietary technology. Indeed, many large and small technology licensing sales have already been made (primarily for the petrochemical processing sector) but there is no reporting requirement for completed sales and to my knowledge there is no way to estimate the size of the transactions that have already been completed. Recent Chinese policy has downplayed the domestic construction or foreign acquisition of complete plants in favor of improving existing enterprises. There have already been a number of transactions involving licensing of technology for existing Chinese factories and more can be expected in the future.

Future prospects for China's foreign trade

The future of China's foreign trade will depend primarily on whether the Chinese domestic economy successfully resolves immensely difficult problems in nearly every part of the economy. The Chinese economy has already been slowed

dramatically by energy shortages and faces even more difficult problems unless the offshore oil exploration yields significant positive results. If it does not, it is quite possible—and even probable—that China will change from a net energy exporter (from which more than 20 percent of foreign exchange is presently derived) to an importer. The balance between food supplies and food demands remains tight and recently Chinese leaders have warned once again against transferring too much land away from grain cultivation. Increasing money incomes for Chinese consumers places further pressures on domestic food supplies. Economic failure in this regard would improve U.S. chances for more sales of agricultural products. In fact, such a scenario would be the most likely opportunity for the United States to increase its share of the China market. However, the necessity to spend substantially increased amounts of foreign exchange on food grains would undermine China's industrialization and could dramatically lower its potential to expand foreign trade in general. Finally, China is in the midst of a massive effort to rationalize and modernize its planning and industrial bureaucracies. Success would mean greater economic strength and an ability to support a more rapidly expanding foreign trade. Success for the present goals of the reformists would also bring about a legal and institutional structure which will further encourage foreigners to move even more aggressively to seek China trade opportunities. Failure for these reforms would not be likely to move China back to the extremes of Maoist self-reliance and Soviet-style heavy-handed centralization of foreign trade decisions. Nevertheless, there are those in China that oppose implementing the reform package as quickly as Deng Xiaoping, Chen Yun and their allies advocate.

There is not space for a full discussion of these issues. In any event, they will be more thoroughly analysed by other participants in this workshop. Since my assignment is United States-China Commercial Trends and Policy, I will restrict my comments to China's foreign trade policy.

A key question is the degree of support that current Chinese foreign trade reforms have among the elite, among middle level bureaucracies and among the masses. No one that I know can answer that question with complete confidence. We know from recent Chinese statements that the amount and the widespread nature of smuggling and corruption have shocked Chinese officials. These problems are apparently causing some important leaders to raise basic questions about how the opening to the West will affect Chinese society.

We also know that the desire to substantially increase China's international economic activity has already led China to begin to substantially alter Chinese traditional business practices. Examples include a willingness to accept credit (Chinese leaders now appear to be debating how much debt to accept on normal commercial terms as opposed to below market, subsidized rates), acceptance of third country arbitration clauses and adoption of standard international practices to protect patents and other forms of industrial and intellectual property. We must recognize that (in addition to opposing such basic changes as a matter of principle and ideology) some Chinese officials are concerned that the reforms will negatively affect their positions and their organizations.

For many thoughtful Chinese, the present policies raise even more basic doubts and concerns than those just mentioned. They wonder if foreign development of China's natural resources and foreign investment and control of manufacturing establishments in China might not undermine China's sovereignty. The Chinese, as we all know, are a very historically minded people and it is no accident that the present discussion of how far these reforms should go has been accompanied by an intensive review and debate over the foreign impact on China since the Opium War.

With all of these problems to consider, it is nothing short of remarkable how much has been achieved in China since Mao's death in 1976 and since the basic reform measures were adopted at the Third Plenum in December 1978. Developing the necessary legal framework for handling the contract negotiations for China's offshore oil development illustrates this point. China has had to develop not only a model contract that will provide a framework for these specific agreements. More importantly, they have had to develop totally new laws on extremely complex tax, environmental protection and resource exploitation issues. In developing these laws, they had to take into account not only their impact on Chinese domestic sensibilities but also make sure that the legislation would not be inconsistent with a great deal of other legislation now under preparation. Moreover, the laws also had to be sensitive to the concerns of the foreign corporations and,

in some cases (e.g., the need to make the Chinese foreign enterprise tax law creditable for foreign tax purposes), to foreign governments as well. The laws affect all foreign companies—not just the oil companies—so that Chinese legal drafters had to be concerned about the precedents they were setting (not to speak of the full range of Chinese bureaucracies that were involved) that will continue to influence China's international economic activities for some time to come.

To be sure, there have been many frustrations and delays since the Chinese began discussion of this project with foreign oil companies several years ago. But, all in all, it is remarkable that the formal announcement that the bid process has begun and has been delayed only by a matter of months and not by years.

The question of Chinese domestic support for present foreign trade policies is one that also must be confronted. Both foreign businesspersons and Chinese senior leaders have continually expressed frustration that the foot dragging and lack of cooperation of middle level Chinese officials has stalled the implementation of economic reforms. I do not wish to minimize these problems, but on the other hand, the last year—particularly since the 6th plenum in June 1981—has produced a situation in which it seems like nearly every important Chinese economic organization is intent on making a substantial commitment to foreign trade.

I have studied the new trend towards setting up spare parts warehouses, training and repair centers for foreign goods in China. One of the striking themes that emerges from this new trend is that many Chinese organizations have obviously concluded that it is in their interest to sign multi-year contracts to either represent foreign companies in China or to facilitate the foreigners' desires to do it themselves (including having technicians and managers stationed in China). Clearly many Chinese organizations are also attempting to find new roles to play as they face orders to phase out of old responsibilities. And there is an obvious feeling that if "I don't get the foreign business first, I will lose out to another Chinese organization." Nevertheless, even though they are often driven by motives to find new responsibilities to justify their continued existence, what is interesting is that so many Chinese organizations are seeking a "foreign connection" to achieve their goal.

Lastly, the same trends are pushing Chinese organizations to aggressively establish overseas offices, joint ventures or at least to independently contact foreign purchasers of their products. My favorite example of this trend involves the attempts of Chinese organizations to sell titanium on the U.S. market. Late last year, we had, at more or less the same time, five different Chinese organizations in the United States all representing themselves as the most effective Chinese unit to supply this product. The traditional exporter of all mineral products (the Ministry of Foreign Trade's Minerals and Metals Import and Export Corporation—Minmetals) has set up an office in New York as has a group associated with Shandong province (one of the regions in China that produces titanium). Separately, a joint delegation of the Third Ministry of Machine Building (which uses titanium to build aircraft) and the Ministry of Metallurgical Industries (which has control over most of the mines) was visiting U.S. aircraft manufacturers. Two other delegations—one of them Guangdong province and another from the head office of Minmetals—were also in the country and also were interested in talking about titanium sales. Needless to say, many U.S. companies were extremely confused and were wondering which Chinese organization they should concentrate their efforts upon. The important point is that this is yet another indication of widespread interest among Chinese economic organizations in foreign trade. It is this willingness to "stick their necks out" that, I suggest, is an indication that a substantial part of the Chinese economic bureaucracy has concluded that present foreign trade policies are here to stay for the foreseeable future.

The goal of present Chinese leaders is to expand their foreign trade in the next decade both in relation to the domestic economy and to world trade. They have apparently concluded that from both economic and political points of view, it is in China's own interest to play a larger role in the world international economic community. Whether they will be able to achieve that goal will, of course, depend on avoiding major domestic obstacles such as an inability to solve their energy or agricultural problems and the avoidance of dramatic political reversals either at home or abroad. Whether they will be successful, of course, is an open question.

The various studies of this issue vary widely in their conclusions. They can be characterized as ranging from exceedingly optimistic with rates of growth in

excess of 20 percent to quite pessimistic with rates of growth as low as 5 percent. If one can assume that China will avoid major economic problems, economic growth rates of around 5 percent appear attainable. Assuming a moderate expansion in the use of credit and a growing importance of foreign trade in this economy, foreign trade growth rates of around 10 percent per annum in real terms appear to be plausible for the decade of the 1980's.

PRESENT AND FUTURE POLICY ISSUES IN UNITED STATES-CHINA TRADE

Previous sections have argued that the political context for our economic relationship with China is that toward a friend with whom we share certain common interests but that it is a relationship that stops short of that with our long standing allies and neighbors. The economic context for our policy toward China is that toward a country that has already become an important trading partner of the United States and whose present policies suggest that its international economic activities will expand further. Moreover, some of its future economic activities (such as the development of its energy resources and the market it offers U.S. firms for agricultural products, industrial raw materials and selected machinery and equipment) may have a significant impact on certain parts of the U.S. economy. On the other hand, it is unlikely that at any time in the foreseeable future China will become a major trading partner of the United States. Its economy is saddled with too many basic problems to expect it to achieve very high growth rates. Similarly, although economic reforms are expected to continue to increase the role of foreign trade, it seems doubtful that China's foreign trade could grow at rates exceeding 10 percent per annum in real terms. With this background I turn to a discussion of eight policy issues that will influence United States-China economic relations in the 1980's. Most of the issues that currently confront United States and PRC policy makers will continue to be problems in the foreseeable future. I have chosen four as examples:

1. *Business facilitation.*—Because of basic differences in the two societies, it will never be possible to achieve exact equality of treatment on all issues. In fact, in some areas of business facilitation, it is the Chinese who are able to provide us with better treatment than we can offer them.

However, in general, our business people are disadvantaged because of the basic differences between an open and a closed society. Most simply, the Chinese have found that they can achieve their purposes by dealing with whichever private institution or level of government will be most enthusiastic about responding to their requests. Even though Chinese society is far from that monolithic institution it once was, it is still a great deal more centralized and disciplined than our own. U.S. businesspersons are also disadvantaged vis-a-vis their Chinese counterparts who do business in the United States simply because of the much greater housing, office and travel facilities available in the United States.

In the last 2 years, progress has been made on obtaining better treatment for U.S. business persons operating in China on visa questions, domestic travel within China, more uniform implementation of Chinese customs laws and informal assurances on office facilities.

These are terribly nitty-gritty, non-glorious type policy issues to keep hammering away at. Unfortunately, unless we are serious about getting some measure of reciprocity for our business representatives and are willing to back this goal up by withholding amenities for their operations in the United States, there will be less progress than there could and should be.

2. *Concern for Chinese imports.*—A large part of Chinese imports are accounted for by very sensitive textile and light industrial products. We have continually tried to educate the Chinese about the areas of greatest sensitivity and to encourage them to adopt price policies that will avoid running afoul of our anti-dumping and market disruption laws and regulations. There are some signs that some of their more sophisticated exporting organizations understand these concerns, but it is certain to continue to produce strains—particularly as other Chinese exporting organizations begin to accelerate their exports to the United States.

3. *Export Controls.*—We have announced a significant liberalization in our Export Control policy towards China and have attempted to streamline the mechanism for approving applications. There have already been significant positive results on both scores. Nevertheless, with some justification, both Chinese

officials and U.S. business people think that implementation has not been as rapid as it should have been. Some business people continue to feel that the treatment of their export applications is inconsistent with our stated policy.

Our task for the immediate future will be to try to make sure that all involved agencies treat Chinese cases in consonance with the President's policy.

4. *Legislative Changes.*—There are a number of laws that still discriminate against China to the detriment of U.S. commercial interests. We embargo 7 furs from import to the United States and our legislation prevents giving economic aid to China. The primary effect of changing these laws would be to bring our legislation into line with the realities of our current China policy and the present situation. Significant changes in our level of trade with China would not result from these revisions, but from the point of view of our relations with Chinese policymakers, our own officials would not have to be on the defensive attempting to justify outdated policies.

The United States, of course, is strongly opposed to tying foreign assistance funds to particular commercial projects. Moreover, foreign assistance for China, if any, is likely to be very small. Therefore, a substantial impact on our commercial relationship with China is not anticipated.

Speaking strictly for myself, however, I believe that some consideration could be given to the commercial implications of foreign assistance. With only a small amount of money to work with, there would be many attractive alternatives from which to choose. I believe that there will be many projects which are fully defensible on their own merits and which, while not conditioned on or directly related to U.S. commercial interests, would, nonetheless, be supportive of these interests. For example, suppose that the Chinese intend to place some of their South China Sea Oil Exploration support activities on the very poor and underdeveloped island of Hainan. A project to improve the transportation and communications facilities might be fully defensible on traditional grounds but would also have the advantage of facilitating an important U.S. economic interest.

Future policy issues of increasing prominence

1. *Industrial Property Protection.*—Present Chinese economic strategy is to downplay buying complete industrial facilities in favor of purchasing technology and selected pieces of equipment to upgrade existing facilities. Moreover, Chinese organizations are also under intense pressure to earn foreign exchange and will certainly wish to export commodities made with imported technology. Finally, while Maoist self reliance is no longer in vogue as an overriding national policy, there remains a substantial bias in favor of depending on China's domestic science and technology to provide most of the inventions and innovations needed by China's industries.

China is committed to the United States-China trade agreement to establishing a patent system that would go a long way towards reassuring U.S. firms about Chinese adherence to basic international standards in this area. However, the adoption and implementation of this new system has been delayed. Inevitably, rumors are circulating that part of the problem has to do with division among the Chinese leadership about how far China should go in adopting international standards. In any event, unless China does make progress in this area, industrial property protection issues will become increasingly contentious in the 1980's.

2. *U.S. Government Support for U.S. firms involved in major projects.*—Despite China's current de-emphasis on capital construction and major projects, there are a number of interesting projects that are currently under negotiation. In some cases—particularly in the energy field—the U.S. Government plays a role either as a direct participant (as in the case of our government-to-government agreement for hydropower and water resources cooperation); necessary involvement because of export controls, government financial assistance and other government regulations (such as those relating to the peaceful use of nuclear energy); or of active assistance and representation to Chinese officials on behalf of U.S. companies. In the hydropower and water resources area, for example, we are hopeful that we can utilize Phase 2 of our government-to-government agreement to involve the U.S. private sector more intimately—perhaps by cooperating with Chinese engineers on a feasibility study for one significant Chinese hydropower project.

3. *Investment Issues.*—The many and varied kinds of equity positions that U.S. companies are establishing in China range from ownership of equipment to small spare parts warehouses, to joint ventures in multi-million-dollar hotel proj-

ects and to potentially very large exposures in large projects in the coal and oil sectors. Political risk insurance is already available through the Overseas Private Investment Corporation. However, it might be worthwhile to consider some broader arrangements in the investment area to address such questions as the dispute resolution and the remittance of profits and other transfers.

Mr. SUTTER. Thank you very much, Mr. Denny.

Our next speaker is Erland Heginbotham. Mr. Heginbotham will look at the issue of United States-China economic relations in light of several factors, one of which is the question raised by Senator Hayakawa at the start of our session yesterday, and that is what effect will increased United States-China economic cooperation and particularly Chinese exports have on U.S. friends elsewhere in East Asia.

Mr. Heginbotham is the former Director General of the Foreign Commercial Service of the U.S. Department of Commerce. Prior to taking that post in 1980, he served as Deputy Assistant Secretary of State for East Asian and Pacific Affairs with responsibilities for regional, economic, and commercial affairs. He also has served as the vice president for development of the Overseas Private Investment Corporation, and has had other posts that have occupied him in East Asia since the 1950's.

Mr. Heginbotham, please.

STATEMENT OF ERLAND HEGINBOTHAM, FORMER DIRECTOR GENERAL, FOREIGN COMMERCIAL SERVICE, POTOMAC, MD.

Mr. HEGINBOTHAM. Thank you very much, Robert.

I am grateful to Senator Hayakawa because he also asked actually one other question on which my remarks will focus, which is, in view of the apparent high risks in United States-China trade, is this an activity which the United States should promote and encourage?

Perspective on this topic, I think, is very important. How do you approach the question of the value and importance of promoting United States-China trade? We tend to look at it really too often, I think, in the exclusive context of the bilateral relationship: should we promote it in that context? Unfortunately, the world is neither so simple nor so easy on choices.

Since managerial talent is a particularly scarce commodity, and since U.S. firms are hard pressed in competitive terms around the world, we have to approach this topic not just in bilateral terms, but in terms of worldwide tradeoffs. How important is it for us to promote China trade? What are the benefits compared to the costs of investing in that effort? Is the return greater than the same effort in another market?

David Denny has given an excellent set of perspectives on the comparative importance of United States-China trade. It always amuses me the way in which history tends to impose ironies upon us which we do not always appreciate. The pattern of trade that he specified is a beautiful demonstration of the extent to which the United States indeed has become an economic colony of Asia. The pattern of our trade is the typical 18th century example of the colony providing raw materials and foodstuffs to the metropol, in return for which it acquires textiles and other manufactured goods. This is the pattern which today is not only common to our trade with China, but also to our trade with Japan.

So, if we are comfortable with remaining an economic colony of Asia, this is a marvelous pattern for us to support, but perhaps we ought to look more intensively at other types of trade opportunities with China. I am sorry I did not come with the statistics to show where China ranks in terms of our trade with Asia in manufactured goods, as opposed to the colonial goods. In that respect, you will find that China is somewhat further down the line, and even less attractive, as a market for U.S. manufactured goods.

As a result, when we look at the opportunities for China trade in manufactured goods, we have to compare the opportunities and costs with those of other markets in Asia, particularly where the growth is high and manufactured composition of imports is greater. In that respect, of course, you have mainly countries like Korea, Taiwan, Hong Kong, Singapore, and increasingly the five countries of the Association of Southeast Asian Nations.

In all of those areas, with the exception of individual ASEAN countries, the United States has a larger, more stable trade in manufactures, than with China. More importantly, trade in these are with countries which are much more market determined, with much less Government intervention. The costs and ease of entry and operation are lower, and the stability of the results tends to be much greater.

China nevertheless remains attractive, but in manufactures, mainly for its potential. The attractions are the relatively favorable growth prospects, even in the Asian context, and the huge size of the market, particularly as concentration on satisfaction of personal and consumption needs takes more of a role.

As I have implied, there are many unusual costs, risks, and disadvantages in efforts to sell to China. In my paper, I concentrate on some of the reasons for the extraordinary volatility in United States manufactures trade with China and why it will likely continue. In fact, I noted last night that an article in the November-December China Review gives a little statistical perspective to that.

That volatility creates unusual risks, and therefore makes the potential costs of the China trade in manufactures particularly great. A decision to tackle that market, therefore, needs to be considered carefully in comparison with other opportunities.

In making this comparison, I start from two particular working hypotheses that are important as a matter of perspective. I believe that the United States as a manufacturing exporter suffers from rather substantial and severe structural disadvantages compared with practically all other industrial nations. For that reason it is vitally important for the United States as a general principle to exploit cost-effective trade growth opportunities, especially in advanced industrial products, and especially in Asia. Mainly by capitalizing on high-growth markets can we maintain and regain our competitive strength.

Second, in looking at China for high-growth opportunities, it is especially important to be selective, since only a relatively few types of opportunities offer clearly favorable conditions for a good and stable return, while the majority are high risk and high cost because of their volatility. So our first step in approaching the China market should be to identify the most favorable types of opportunities for the American Government to promote.

In other words, as we look at what the Government can do, we have to be particularly sensitive to the high risks and the high costs of

China trade, not encourage companies in risky directions and at least alert them to areas where the risks and costs may be particularly great.

The following are categories where I think the opportunities are less risky, and therefore more deserving of our attention. Since the China market requires an extraordinary investment of management and technical effort, large companies, well diversified in a range of products China is likely to need, are best able to afford the long-term development investment required. Especially for an industrial nation as uniquely short term oriented in assessing its costs and profits, as the United States, this has to be a major consideration for United States firms. Only in rare cases, when China makes the initial contact with a company, or in other special circumstances which minimize the lead-times, is it likely to be sensible for medium, smaller, and less diversified companies.

Second, a few sectors offer unusual growth potential and comparative stability of demand, mainly those already covered well during the past day: Energy development—especially petroleum, textile materials, agricultural sector support commodities such as chemical fertilizers, and insecticides, and probably also transportation and telecommunications. In these sectors, Roger Sullivan's remarks have an especially important role. His political precautions about the general health of our bilateral relationship being the prime determinant of economic prospects then becomes perhaps the dominant theme for companies to consider.

Third, given the volatility of China's demand and trade decision-making, one type of organization is especially favorable to achieving comparatively cost-effective results from efforts to develop the China trade. This is the large, broad spectrum trading company dealing in both imports and exports. Unfortunately, the United States is an underdeveloped country in this respect and in the poorest position of any industrial nation to utilize trading companies to develop its own trade potential. That is a great irony.

As a result, I would add to the very useful list of Roger and David of policy priorities, that passage of the export trading company legislation, particularly with strong provisions for bank ownership of trading companies, is an extremely high priority for U.S. policy in the direction, as Roger said, of "getting out of the way of American business letting them do what other competitors do."

Fourth, small and medium companies, while facing the greatest disadvantages and risks in confronting the extremely large front end development costs and high volatility of China trade nevertheless have good prospects in a few special sectors we have identified. For example, in petroleum development, a lot of small service companies will have very good opportunities, and, of course, the use of trading companies.

One other approach to China trade is particularly worth exploring. We don't know enough about it yet, but it appears to me one of the most promising routes for doing business in China, particularly for the medium and small company. This is the compensatory trade arrangement.

There are to date about 400 of these arrangements, compared with only 29 approved joint ventures. Wei Yuming of the Foreign Investment Council has indicated that the Government plans to place a

very high priority on this technique. Rather than hundreds, China expects to approve literally thousands of these ventures.

This formula involves a mix of investment and trade but it offers both potentially a more stable kind of trade relationship with China and one that also plays directly—as someone said yesterday—plays directly to the point of improving American competitiveness through an export base in Asia. So, I think this technique has unique possibilities, and also points up the value of working through Hong Kong, with Chinese investors and affiliates, as a means of doing business.

I am sorry if I am running a little bit long, but let me just take another minute to touch on the impact of China's modernization on Southeast Asia—the impact. I go into that in some depth in my paper. In a nutshell, I do not believe that there is anything significant to fear from China as a competitor to other Southeast Asian nations. The general dynamism of that region, the necessity of those countries to compete and to fit into niches in the competitive strengths of the very, very dynamic and very quickly responsive other countries of Asia, are far more of a challenge to the economies of those countries than the Chinese economy. In other words, if the ASEAN countries can achieve an industrial place in the world, in competition with the Koreans, the Taiwanese, the Singaporeans, they will have to surmount a far bigger challenge. In fact, they will do so with investments from those countries. I just don't see China being able to move swiftly enough to cause a serious problem. It may have some highly focused impact on a few products, but I think those economies are very well equipped and in position to respond to such challenges.

I would like to point out, for purposes of enlivening the discussion, my philosophical difference with the viewpoint that "all the American Government needs to do is get out of the way of American business." This neglects a completely other aspect about which we are all too ignorant and naive, which is that we live in a world in which the United States is not the only country.

Other countries have governments which have very aggressively promoted their trade interests through all kinds of techniques which are in some cases not even known to us but in other cases are all too well known and all too effective. So it is not enough simply to step out of the way because in many cases that simply means U.S. firms will be utterly crushed by Government-supported marketing techniques of the French, Japanese and other competitors.

Getting out of the way is not enough. What we also have to do is either equalize the kinds of Government support that American business gets in international competition, or we have to negotiate away those inequalities.

Just to cite a single example, providing ourselves with major trading companies is one of the best ways. Also I would propose that rather than doing an aid program in China to promote our trade, we could provide a modicum of grant feasibility study money in highly focused areas, with the support of U.S. business, where we could do grant feasibility studies intentionally designed to provide a lead and a leading role for American companies to get in on important aspects of Chinese development.

[Mr. Heginbotham's prepared statement follows:]

PREPARED STATEMENT OF ERLAND HEGINBOTHAM

U.S. NATIONAL ECONOMIC INTERESTS IN CHINA TRADE

This paper addresses two questions from a U.S. national economic interest viewpoint:

First: Is U.S. Government promotion of U.S. trade with China significantly beneficial or contrary to U.S. international economic interests?

Second: Is China's modernization harmful or beneficial to other Asian economies in which the United States has a keen interest?

A. U.S. policy interests

To determine U.S. economic interests in China trade requires consideration of (1) the attributes of the trade and their net costs and benefits, and (2) the relevance of United States-China trade to the U.S. trade position and U.S. trade competitiveness in the Asian region.

China's size excites dramatic trade expectations but many aspects make it uniquely difficult and challenging. These difficulties make it particularly important to consider the balance between the costs and benefits of promoting United States-China trade. They limit the number and types of firms which can profitably invest in China export efforts.

Selectivity is perhaps most important of all in developing a strategy toward China trade. Some types of transactions and certain sectors are likely to be much less risky and unstable than others and the differences in risk and instability are likely to be great as between the safest and the riskiest.

The following are some important recent characteristics of China trade:

1. Rapid overall trade growth, supported by rapid underlying growth of the economy as a whole: China's ability to sustain over several years a real GDP growth of about 7 percent and a trade growth in normal terms of about 25 percent (equivalent to roughly 12 percent in real terms), have made it a highly appealing candidate for export efforts. Even a somewhat lower growth rate of about 5 percent expected in 1982 is impressive in a world generally faced with stagnation and recession. Increased PRC policy emphasis on improving consumer income and access to goods further heightens the attractions of the market. Sustained growth of personal income in a such a colossus inescapably excites expectations.

2. Considerable volatility of national economic policies and implementation measures: Frequent changes of emphasis and even direction are not surprising when undertaking modernization goals as challenging as those in China. The switch of emphasis from heavy industry to light, and the increase in priority for energy and transportation were consequences of adapting to problems on the road toward modernization. So was the modest retreat from decentralization. Certainly other important shifts will follow. The goals sought are so massive and consequently these shifts in policy tend to be far reaching and have a greatly magnified effect on trade. As one of its important roles generally—and to a uniquely important extent in China—trade is the residual means by which a country makes up for gaps in its needs when domestic solutions are insufficient.

To illustrate with a make-believe example:

	1991	1992	Percent change
Steel consumption.....	100	110	+10
Domestic steel production.....	99	100	+1
Imports required.....	1	10	+1,000

This illustrates an extreme case of how the impact of a government decision to postpone investment in expansion of heavy industry production can have a disproportionate affect on trade.

3. A high proportion of China's imports shows great volatility of demand. When you look at the overall statistics on the growth of manufactured imports the picture is one of impressive and apparently steady growth. When you look at the details, some whole categories of imports and many more individual products show great import bursts followed by virtual disappearance. The first and second tables at the end of this paper illustrate this point. For example, import of iron and steel mill products burgeoned in 1979 but fell off sharply in 1980 and were insignificant in 1981. Aircraft imports experienced an even shorter burst.

4. The relatively few categories in which there is comparative stability in import growth are essentials which play massive roles in the economy: e.g. food, fertilizer and textile raw materials.

5. There is an exceptionally large "residual" aspect to China's import trade, stemming from its long period of self-reliance. China still uses import policy as means of meeting unexpected shortfalls in domestic performance more than most economies because it has yet to build up much role for imports as an integral part of ongoing production systems. This residual character is common to all trade but is uniquely great in China's case, having the effect of amplifying the volatility of import changes more than in most economies.

6. The exceptional extent to which government decision-making dominates foreign trade decisions: Ironically, even PRC decisions to move toward more market determination and decentralization of trade decisions, followed by partial reversals and re-reversals of these moves, have tended to amplify the volatility caused by the large government role.

7. Concentration of trade relations in investment-associated activities: Since China in the past has tried to limit the extent to which its on-going production depends on inputs from foreign trade, the proportion of trade in manufactured goods influenced instead by investment- and major project-related needs is unusually great. These involve limited periods with large imports of equipment, machinery and construction supplies for specific but time-limited projects or development programs, by contrast with needs of a more stable nature such as chemical fertilizers. Thus to an unusual degree the commodity composition of China's import trade is determined by investment-related activities such as:

a. Major projects; and

b. Compensatory trade arrangements (a form of investment partnership).

8. The continuity of agriculture, energy, transportation and communication problems gives imports associated with their development greater prospects for sustained growth—though not without ups and downs. Announcement of the opening of 58,000 square miles of offshore waters for bids by 46 companies heightens prospects for early resumption of rapid import expansion in oil-related requirements.

B. Strategic economic aspects of China's modernization efforts for U.S. trade policy and promotional efforts

1. Strategic considerations for United States:

a. The opening of trade relations with China has caused a few minor trade shocks from the expansive flow of Chinese textiles and garments into the U.S. market, aided and abetted by aggressive sourcing by major U.S. importers and merchants. The range of Chinese goods which are directly competitive with U.S. goods is very limited. Nor can one foresee in this decade the kind of competitive challenges which we already face from our vigorous free-market trading partners in Asia—Korea, Taiwan and Singapore—not to mention Japan.

b. China's import needs at least for the first half of this decade will continue to focus primarily on supplying agricultural and raw material needs, and equipment with which to meet China's energy, transportation and communication needs. Its import requirements will also undoubtedly include industrial machinery, some of which may produce for export. However such imports are likely to be a very modest part of its total import needs, and are unlikely to give it export capability in products which will be directly competitive with the kinds of products which the United States must dominate to retain its international economic competitiveness and trade influence.

c. For these two reasons, I cannot foresee in this decade any bilateral economic reasons to hesitate about promoting rapid growth of U.S. trade with China. Nor, as I will indicate later on, can one see any indirect disadvantages likely to be caused by China's modernization and its likely trade impact on our other Asian trade partners.

2. Rather the strategic economic interests of the United States are better served by our attempting to maximize on a cost-effective basis the promotion of United States-China trade, because of an urgent need to strengthen our overall international trade competitiveness:

3. The following excerpt from a recent speech I made on international trade competition provides some useful background on why it is important for the United States to promote aggressively its trade competition in Asian markets particularly:

American industry has great obstacles of its own to overcome. The United States used to determine the terms and nature of international competition. Now clearly Japan does in an increasing number of industry sectors vitally important to industrial strength and competitiveness in the 1980's. Japanese firms have at least four powerful competitive advantages which must concern us:

(1) First, Japanese firms go for the long run. Their owners and backers don't worry about quarterly or even annual results. Up to 80 percent or more of their capital is long-term financing, either from loans or internal financing. Market share and business volume is what they are after.

American firms by contrast are obsessed by stock market assessment of latest quarterly financial results and its impact on their stock price (cost of capital). The consequence is a very destructive and distorting preoccupation with near-term results, dubbed by a recent *Business Week* article "a fatal fascination with the short-run". One quotation bearing on the effect of recent tax legislation illustrates my point:

Alfred Rappaport, Professor of Accounting and Information Systems at Northwestern University says in a May 4, 1981 *Business Week* article: "What is desperately needed are incentive systems that motivate executives to make decisions consistent with the long term interests of the company. Only then can we reasonably expect to see the full impact of tax incentives intended to spur investment in U.S. industry."

(2) Second, Japanese high-technology firms usually employ a "learning-strategy". They develop their competitive edge in faster growing foreign markets, not initially in the United States. U.S. firms and policymakers who think we have to improve our ability to compete with Japan in the U.S. market have lost the battle before it begins. By the time the Japan's high technology products reach U.S. shores, they have in most cases already achieved insuperable competitive advantages, in price, quality and often in service.

It is vital for us all to understand this process. In new industries, research indicates, producers can often achieve up to 30 percent or greater reductions in cost per unit of output with each doubling of productive capacity—the "learning curve." Each expansion permits improvements in use of equipment, technology and other learning benefits. Japanese firms capitalize on this principle above others. Uninhibited by demon short-run profits, the Japanese look for the fastest growing markets and aim to win sales to maximize growth. Never mind if you have to sell at little or no profit for the first few years. Sometimes the Japanese Government intervenes to reduce the number of Japanese competitors so those which remain can benefit from still higher rates of growth.

While U.S. firms compete mainly against each other for the slower growing U.S. market, inhibited by short-term profit considerations and stockholder demands for high profit margins, the Japanese redouble their 30 percent cost reductions more rapidly in the fastest growing international markets, in the process speeding up addition of product features and quality improvements. Once the Toyotas, Datsuns and Mazdas begin to land in the United States, the trend of success is well established.

C. Key implications of China's modernization efforts for implementation of U.S. trade policy and promotional efforts

1. Despite its rapid growth and huge size, China has certain severe limitations as a market and therefore our policies for promoting trade need to be specialized and qualified.

2. High degree of uncertainty about continuation of demand in specific products and product categories;

3. Particularly high risk for medium and small companies:

a. Compensatory trade arrangements appear most promising.

b. Association with HK or Singapore investors?

4. For larger companies, major projects particularly in energy sectors, still appear promising, although subject to unusual uncertainties of timing and terms.

5. Consumer-related requirements appear next most promising, but exporting may be less promising means of market penetration than compensation trade arrangements.

a. Wei Yuming, Vice Chairman of the Foreign Investment Control Commission indicates government plans to approve thousands of such arrangements.

- b. Currently these number roughly 400 compared with only about 20 joint ventures approved.
6. The foregoing characteristics of the Chinese market argue for the following emphases in development of an effective U.S. Government role in the promotion of United States-China trade:
 - a. Considerably strengthened leadership and more aggressive policies by the U.S. Trade and Development program, working closely with the Foreign Commercial Service in China and Hong Kong, to explore more opportunities for grant feasibility studies which might open the way for a larger U.S. economic/commercial role in China.
 - b. Specially tailored OPIC coverages to protect U.S. firms against unexpected changes in PRC policies;
 - c. Consideration of ways the U.S. Government can foster, make more effective, U.S. firm marketing strategies based on compensating trade arrangements;
 - d. Concentration of promotional efforts on energy, communications and transportation sectors where U.S. has many competitive goods and services to offer; such a concentration may require again some specialized OPIC support to cover risks in coal and petroleum projects;
 - e. Consideration of the feasibility of creating special OPIC coverage for technology sales to China; and
 - f. Concentration of U.S. Government facilitative assistance in (1) more commercial officer support in Hong Kong, in light of the uniquely great role that Hong Kong plays as the third-largest source of China's imports and as the leader in compensatory trade and joint venture deals. (2) enhanced U.S. Embassy ability to develop early-warning capability on changes in PRC economic policy implementation measures and to provide analysis of the changes in trade composition and patterns, so that U.S. firms can anticipate product volatility more quickly.
7. Present PRC concentration on energy, transportation and light industry development do not appear to threaten U.S. trade interests or competitiveness. Rather these priorities plus the rapid growth of the economy as a whole and of popular income in particular and PRC emphasis on greater satisfaction of consumer needs appear to offer a highly favorable pattern of opportunities for U.S. exporters.
8. China's growth at a real rate comparable to those of the fastest-growing Asian nations, in an Asia-Pacific region of higher than average GNP growth compared with the rest of the developing world, make it a particularly important market for us to take maximum advantage of export growth opportunities.
9. Compensatory trade arrangements offer unique opportunities to tailor our marketing by identifying production projects where a large China market can be penetrated by combining our comparative advantages in product design, quality and technology with China's advantages in labor, land and agriculture.
10. Overall, most opportunities outside compensatory trade arrangements are more than normally subject to great volatility and uncertainty. Companies with the greatest comparative advantage in tackling the China market are:
 - a. broad spectrum trading companies: they get a high return from their efforts by being able to watch for and act on (1) a broader variety of opportunities than organizations with narrower interests; and (2) increased requirements for compensatory or counter-trade arrangements;
 - b. energy-related companies;
 - c. large, broadly diversified manufacturing companies, again particularly those with capabilities in several sectors including energy, transportation, chemicals, electronics and similar products with a mass utilization market in China;
 - d. firms having types of technology of current pressing importance to China, such as process control, machinery and equipment manufacture and consumer electronics;
 - e. firms adept at working out cooperative production arrangements with foreign partners such as are involved in compensation trade, with the U.S. partner providing equipment, technology and training in return for product.
11. The China market will provide less satisfaction for firms not in the foregoing categories, particularly those looking for stability and steady growth. For at least the next five years, such markets as Taiwan, Korea, Australia and the ASEAN countries offer more diversified and stable market conditions and more dependence on market-determined opportunities while lacking some of the more dramatic opportunities and prospects of the huge China market.

D. Key aspects of China's modernization impact on other East Asian economies

1. In direct trade, 1980 data show:

a. Vast majority of China's exports to Southeast Asia go to HK and Singapore (80 percent).

b. Content (as typified by exports to HK—70 percent of its EA total) is heavily concentrated in textile yarn, fabric and clothing (29 percent), foodstuffs (26 percent) and petroleum and other crude materials (16 percent). The rest is spread widely over an array of 11 key manufactures (24 percent) and chemicals (5 percent).

2. In competitive trade to countries which constitute major markets for South East Asian exports, as typified by China's exports to Japan—the trade composition shows much the same pattern (1980 data):

[In percent]

	Hong Kong	Japan
Textile yarn, fabric, and clothing	29	16
Foodstuffs	26	15
Petroleum, coal, crude materials	16	58
Chemicals	5	4
Other nontextile manufactures	24	5

3. China's present emphases on energy, transport and light industry suggest continuation of this pattern, which does not appear threatening to the economies of any of the ASEAN countries or NICs of East or Southeast Asia.

4. In fact the strengths of these other Asian economies are precisely in:

a. Their ability to maintain high economic growth rates despite a depressed world economy and growing competition from both more and less industrially advanced nations;

b. Achieved generally through growing diversification, especially toward higher technology industries, and through up-grading product sophistication and quality in the face of competition.

5. While China has had a trade deficit of about \$1.6 billion with the advanced nations of Asia (Japan, Australia) over the past 3 years, its surplus with developing Asia has grown roughly \$1 billion a year.

	1978	1979	1980
Japan and Australia	-1.5	-1.6	-1.6
Southeast Asia	+2.8	+3.4	+4.3
Hong Kong	+2.2	+2.6	+3.2
Singapore	+ .3	+ .2	+ .3

Its surpluses with Indonesia, the Philippines and Thailand were smaller but approached those of Singapore in 1980. However, these data probably neglect some exports to China through Hong Kong, so may well be exaggerated. In any event they do not appear to be a significant negative.

The meaning of the China-Hong Kong trade data is a whole special study, given the special role of Hong Kong as a point of re-export. This trade pattern appears part of the vitality of the Hong Kong economy rather than a problem for it.

E. Implications for U.S. interests and policies in Southeast Asia

1. On balance, then, China's modernization priorities do not certainly at this stage—the first half of 1980—appear to be a threat or problem for the economies of Southeast Asia. In a competitive context, the nations of that region face the difficulty of developing competitive exports in a region of trade partners which are generally more dynamic and aggressively competitive in international trade than China. This fact gives more weight to a more complementary context—China is more a valuable source of raw materials, foodstuffs, energy resources and light industrial goods which meet needs of these economies more than it is an immediate competitor. The textile industry is perhaps the one exception, given its importance in several ASEAN countries. Even in this industry the specialized materials and artistic techniques developed in ASEAN countries will limit the impact of competition.

2. By the time China's economy has evolved to a more sophisticated industrial level, the widely diverse natural endowments of the varied nations of Southeast Asia, and the dynamic competition between the market economies of the region, are likely to advance them into areas of specialization which will limit the scope of trade competition with China.

3. On balance, then, the United States can look at China's modernization and the opening of its economy to market forces as a positive development for Southeast Asia—a source of supply, and possibly an important future market.

4. This mildly positive assessment is qualified however by a residual suspicion of China's political intentions in the region, particularly by Indonesian authorities, which will continue to limit trade development.

TABLE I.—LEADING U.S. MANUFACTURED EXPORTS TO CHINA, 1978-81
[In millions of U.S. dollars]

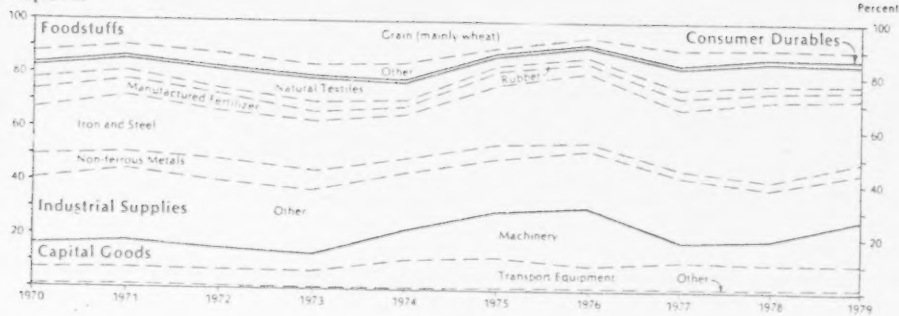
	1978	1979	1980	1981
Textile yarns, fabrics.....	1	33	134	284
Synthetic rubber and resins.....	6	31	170	123
Fertilizer.....	15	45	153	131
Paper, paperboard, and paper stock.....			197	130
Logs and lumber.....			99	42
Chemicals.....			91	66
Scientific and control instruments.....	12	47	46	55
Mining and drilling equipment.....	33	59	41	29
Ships and boats.....			3	20
Iron and steel mill products.....		157	42	
Aircraft.....			147	

TABLE II
Commodity Composition of China's Foreign Trade, 1970-79

Million current U.S. dollars, exports (ab) imports (1970-76 cif, 1977-79 fob)

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Imports										
Capital goods <i>Of which:</i>	375	420	443	725	1,650	2,210	1,840	1,240	2,010	3,870
Machinery	193	215	210	310	770	1,265	1,300	500	935	2,430
Transport equipment	160	185	213	390	835	890	470	640	945	1,245
Electrician instruments	15	10	15	15	40	30	60	75	85	150
Consumer durables <i>Of which:</i>	15	15	20	40	45	35	30	40	100	290
Washwearables	5	5	5	20	20	15	15	15	45	75
Foodstuffs <i>Of which:</i>	195	320	510	1,080	1,600	900	565	1,110	1,350	1,860
Grains	280	215	345	840	1,180	675	325	655	965	1,430
Oilseeds ^a	0	0	10	65	160	15	5	115	35	115
Sugar	60	20	155	135	175	160	200	300	265	200
Industrial supplies <i>Of which:</i>	1,460	1,555	1,875	3,380	4,125	4,250	3,570	4,230	6,850	8,320
Natural textile fibers	95	125	215	450	520	260	190	420	695	99
Synthetic textile fibers	15	15	25	35	95	95	115	160	175	155
Paper and paperboard	13	10	20	35	100	80	45	60	95	160
Wood pulp	—	—	—	—	—	—	—	—	—	—
Rubber ^b	80	60	70	170	165	155	155	205	190	310
Petroleum and products	—	—	—	—	75	105	45	40	55	40
Manufactured fertilizers	140	135	145	210	220	405	230	320	430	615
Crude fertilizers ^c	—	—	—	—	—	—	—	35	50	70
Plastic materials	30	20	35	50	125	70	90	90	130	150
Metalliferous ores and scrap	—	—	—	—	110	125	125	110	160	140
Iron and steel	405	465	510	930	1,210	1,550	1,445	1,445	2,870	3,310
Non-ferrous metals	210	150	235	410	415	450	260	250	410	490
Industrial metal products ^d	—	—	—	—	65	125	90	55	115	175
Chemical elements and compounds ^e	—	—	—	—	—	—	—	270	355	385
Total	2,245	2,310	2,850	5,225	7,420	7,395	6,005	6,615	10,305	14,345

Imports



SOURCE: 1970-76: Richard Bahsavage and John Davis, "China's International Trade and Finance," in U.S. Congress Joint Economic Committee, ed., *China Economy*, Fall-Winter 1976, pp. 737-38.
 1977: National Foreign Assessment Center, *China: International Trade Quarterly Review, Second Quarter, 1979*, January 1980, pp. 16-17.
 1978-79: National Foreign Assessment Center, *China: International Trade, Second Quarter, 1980*.

¹Figures may be converted to job using ratio 1:0.91. This formula may cause distortion in the case of commodity categories with a job ratio which differ from this average ratio.
²Oilseed imports almost exclusively soybeans.

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TABLE III.—CHINA'S TRADE BALANCE AND CHINA'S TOTAL EXPORTS
 [In millions of U.S. dollars]

	China's trade balance (annual)			China's total exports (annual)		
	1978	1979	1980	1978	1979	1980
World.....	-235.6	-565.3	240.0	10,085.5	13,718.1	19,588.5
Non-Communist countries.....	-261.1	-424.7	228.3	8,522.9	12,017.8	17,642.5
Developed countries.....	-3,491.6	-4,525.4	-5,245.5	3,776.1	5,642.6	8,262.7
East Asia and Pacific.....	-1,515.3	-1,545.9	-1,643.1	2,107.1	2,993.2	4,422.5
Australia.....	-344.0	-609.8	-552.0	139.5	166.3	244.1
Japan.....	-1,126.4	-880.2	-969.9	1,947.5	2,793.3	4,138.7
North America.....	-900.2	-1,493.5	-3,309.3	406.5	737.0	1,187.7
Canada.....	-359.3	-363.9	-609.8	82.8	142.8	132.2
United States.....	-541.0	-1,129.6	-2,699.5	323.6	594.2	1,055.5
Western Europe.....	-1,076.0	-1,486.1	-293.2	1,262.5	1,912.4	2,652.5
Belgium.....	-166.3	-62.4	60.8	39.1	67.0	165.1
France.....	-2.9	-54.9	103.4	196.3	284.3	406.4
West Germany.....	-676.5	-1,028.3	-442.8	318.7	464.2	702.6
Italy.....	-14.3	66.0	125.4	174.1	344.3	379.8
Netherlands.....	-25.9	-23.4	90.0	109.1	136.0	237.1
Spain.....	-6.9	-12.4	39.0	59.4	115.3	102.5
Sweden.....	-35.0	-45.1	10.3	48.4	68.4	93.0
Switzerland.....	-51.1	-71.4	-72.5	43.5	47.5	66.8
United Kingdom.....	10.1	-198.0	-77.4	185.7	255.0	316.5
Less developed countries.....	3,230.5	4,100.8	5,473.8	4,746.8	6,375.2	9,379.7
Southeast Asia.....	2,810.3	3,388.4	4,329.2	3,197.3	4,271.1	6,285.0
Hong Kong.....	2,186.5	2,638.6	3,151.6	2,249.4	3,020.8	4,400.8
Indonesia.....	116.2	125.3	188.5	116.2	125.3	188.6
Malaysia.....	100.2	30.1	24.4	210.6	212.0	241.4
Philippines.....	64.8	70.0	165.8	112.2	121.1	210.5
Singapore.....	267.9	221.8	291.3	325.8	391.6	598.5
Thailand.....	3.1	153.4	273.0	79.9	230.4	396.8
South Asia.....	25.9	139.5	-46.8	158.2	262.8	320.8
Bangladesh.....	18.0	45.7	44.9	42.4	65.1	76.0
Pakistan.....	48.7	92.4	-61.4	79.4	117.4	159.8
Sri Lanka.....	-33.6	8.5	-1.5	27.6	63.6	48.8

TABLE IV.—CHINA: EXPORTS TO JAPAN AND HONG KONG

[In millions of U.S. dollars]

Commodity	1979				1980				Annual			
	I	II	III	IV	I	II	III	IV	1981, I	1978	1979	1980
CHINA: EXPORTS TO JAPAN ¹												
Total, exports.....	543.4	672.0	780.2	795.6	812.1	1,085.4	1,071.8	1,190.2	1,041.3	1,947.9	2,791.2	4,139.5
Foodstuffs.....	150.8	138.8	147.1	184.2	142.1	146.3	144.6	206.2	156.9	458.3	620.9	639.1
Meat.....	4.5	6.2	9.1	10.0	6.2	7.4	8.4	14.0	10.3	19.5	29.9	36.0
Fish.....	37.5	40.7	47.5	38.6	37.4	33.3	50.4	43.1	36.5	123.0	164.3	164.2
Dairy goods.....	4.2	4.4	5.1	4.6	5.5	5.5	6.6	8.6	7.1	18.7	18.2	26.2
Fruits and vegetables.....	26.5	18.1	13.1	46.8	19.5	13.5	12.3	62.7	29.6	92.7	104.5	107.9
Coffee, tea, spices.....	3.6	3.0	3.2	5.4	4.9	5.2	5.1	4.8	5.1	9.9	15.1	19.9
Oil seeds.....	37.9	22.3	25.8	24.5	21.2	27.7	10.9	17.4	18.2	41.4	110.5	77.2
Prepared foodstuffs.....	14.8	15.0	16.2	19.2	20.7	16.8	17.4	20.8	24.7	52.6	65.3	75.6
Crude minerals and metals.....	202.2	242.0	381.3	379.7	458.4	586.8	657.3	705.9	607.7	831.1	1,205.2	2,408.3
Natural steatite.....	13.4	13.6	16.3	20.2	23.6	23.9	24.9	25.9	19.9	39.3	63.7	111.6
Coal.....	12.5	13.1	19.3	20.5	17.7	23.9	38.0	32.0	29.6	35.1	65.3	111.6
Crude petroleum.....	163.0	197.7	307.9	281.9	355.7	440.5	508.7	562.1	477.2	726.2	950.6	1,867.0
Petroleum products.....	8.6	14.7	30.6	50.8	53.2	87.6	76.4	75.2	73.8	21.6	104.7	292.4
Chemicals.....	17.4	24.4	30.7	37.1	22.7	52.1	44.4	46.5	43.4	52.1	109.7	165.6
Inorganic chemicals.....	2.1	2.1	2.4	3.8	3.2	7.6	10.3	11.0	12.4	5.8	10.4	32.0
Organic chemicals.....	3.2	6.9	14.4	16.3	7.2	19.9	18.1	19.7	15.2	10.9	40.8	64.9
Essential oils.....	1.0	0.9	1.8	1.6	0.9	2.0	1.1	0.8	1.1	1.8	5.2	4.8
Pyrotechnics.....	3.2	3.8	3.1	4.1	2.2	5.4	2.4	5.5	7.8	6.2	14.2	10.5
Rosin and resin.....	5.6	8.0	5.3	7.9	5.9	11.5	6.4	6.4	7.8	19.9	26.9	30.1
Crude materials.....	12.6	18.3	20.1	20.5	13.3	19.6	14.5	12.1	10.5	40.6	71.5	59.5
Raw hides and skins.....	1.4	2.0	1.7	2.1	1.9	2.6	2.2	1.6	1.1	3.2	7.2	8.3
Furskins and products.....	5.6	8.7	7.5	8.5	3.2	4.5	5.6	5.3	4.6	21.8	30.3	18.6
Wood.....	4.7	6.0	9.0	7.8	6.8	10.8	5.2	4.5	3.8	14.1	27.5	27.3
Fabrics.....	124.8	210.4	172.2	137.3	131.9	208.1	171.4	147.0	151.3	472.8	644.7	658.4
Silk, raw and cocoons.....	30.9	78.0	30.4	9.8	14.3	55.7	15.5	5.6	13.0	143.1	149.1	91.1
Silk products.....	17.3	29.0	26.1	22.2	20.0	20.5	16.9	16.5	18.0	81.0	94.5	73.8
Cotton fabrics.....	24.9	29.3	22.5	22.2	20.4	24.7	17.0	26.3	33.3	74.5	98.9	88.3
Rugs and carpets.....	5.1	7.8	9.0	9.2	5.9	11.3	12.2	8.3	5.1	6.4	31.1	37.7
Clothing.....	26.0	33.6	53.4	42.7	44.5	53.0	74.5	52.3	44.4	78.4	155.7	224.4
Other textile art.....	9.4	13.1	13.8	16.3	10.7	20.6	12.4	13.9	8.9	36.2	52.7	57.6
Other manufactured.....	35.5	38.1	28.8	36.8	43.8	52.5	39.6	72.7	71.6	93.0	139.2	208.6
Footwear.....	1.6	1.3	2.4	2.7	3.4	2.7	4.6	4.2	4.9	3.4	8.0	15.0
Base metals.....	4.1	4.0	4.5	2.7	2.3	3.6	5.8	38.0	34.6	7.1	15.4	49.7
Machinery.....	12.6	16.2	4.7	6	6	1.5	9.9	1.1	6.9	26.1	42.2	4.1
Basinetwork.....	2.4	2.6	2.4	2.2	5.8	19.3	6.2	6.1	2.7	11.2	9.5	16.0
Artwork and antiques.....						4.9	2.9	2.5				

Commodity	1979				1980				Annual		
	I	II	III	IV	I	II	III	IV	1981, I	1978	1979
CHINA: EXPORT TO HONG KONG²											
Total, exports.....	596.9	693.5	771.0	964.5	891.0	1,064.1	1,120.7	1,321.5	1,149.0	2,249.4	3,026.0
Foodstuffs.....	197.1	194.9	242.6	267.7	246.0	259.4	290.4	339.1	292.8	828.0	902.4
Live animals.....	54.7	56.6	66.1	65.8	65.3	77.0	83.6	87.0	76.2	245.5	243.2
Meat.....	27.8	22.0	28.8	41.5	39.3	34.2	38.9	55.4	39.0	109.0	120.1
Dairy products.....	13.5	17.0	15.4	13.7	13.0	17.6	17.6	13.3	14.3	58.9	59.4
Fish.....	23.1	23.7	31.8	34.5	26.1	28.9	30.8	41.1	30.8	84.8	113.1
Fruits.....	21.8	22.8	21.4	26.1	29.7	28.7	28.9	30.9	32.9	84.9	92.1
Grains and vegetables.....	36.5	34.4	56.3	60.3	42.1	42.9	59.7	70.4	58.1	166.8	187.6
Sugar and honey.....	3.1	3.4	3.5	3.1	4.6	6.2	9.6	8.6	8.5	14.2	13.1
Coffee, tea, and spices.....	8.3	5.8	7.0	9.6	8.1	5.5	7.4	10.0	10.6	26.4	30.8
Beverages.....	2.8	3.6	4.3	3.6	9.5	9.3	5.3	9.7	9.5	14.8	33.8
Crude materials.....	95.5	118.7	125.1	140.6	174.8	182.4	184.5	146.7	191.4	325.9	479.9
Oilseed.....	3.2	2.3	3.4	3.7	4.4	4.7	5.1	5.9	19.1	8.3	12.6
Pulp and waste paper.....	(¹)	(¹)	(¹)	(¹)	(¹)	(¹)	(¹)	(¹)	(¹)	(¹)	(¹)
Textile fibers.....	5.7	4.9	5.1	6.3	6.0	7.0	7.9	10.1	13.3	16.8	22.0
Crude fertilizers.....	3.1	4.0	4.3	4.8	5.1	6.8	5.1	4.3	4.5	12.7	16.2
Crude, animal material.....	26.6	26.3	19.5	34.4	36.4	35.5	24.4	35.5	30.5	105.4	106.7
Petroleum and products.....	50.3	71.3	85.7	83.6	115.6	118.7	132.8	81.7	113.6	160.5	291.0
Vegetable oils.....	5.2	7.0	4.4	5.5	4.7	4.3	5.3	6.2	4.0	17.2	21.1
Chemicals.....	27.0	35.0	38.8	50.3	52.3	53.8	48.3	63.1	54.2	83.7	151.1
Organic chemicals.....	4.1	5.8	6.0	7.8	8.8	7.7	9.9	8.4	7.5	13.9	21.6
Dyeing materials.....	2.7	3.2	3.3	4.4	3.8	3.1	2.6	6.4	4.2	9.6	13.5
Medicinal products.....	7.8	8.8	8.5	12.1	10.0	10.0	12.1	15.8	13.0	25.3	37.2
Essential oils.....	2.6	3.0	3.2	3.9	4.2	4.8	4.2	4.8	4.9	9.4	12.7
Explosives.....	5.5	6.5	3.3	4.6	8.1	8.3	7.9	9.1	9.4	13.5	20.0
Resins and plastics.....	9	2.9	9.1	4.6	9.6	10.2	2.3	6.4	4.3	1.5	23.6
Marufactures.....	275.8	343.1	362.8	503.7	416.4	566.8	593.2	769.8	608.7	1,005.5	1,485.3
Leather.....	7.9	9.7	9.4	12.8	9.9	14.0	13.8	15.9	8.9	23.9	39.8
Paper.....	8.0	11.1	12.0	13.9	14.4	16.7	16.4	18.7	15.3	34.2	45.0
Yarn and fabrics.....	129.9	141.1	141.4	206.9	159.0	206.2	190.3	273.3	221.5	456.0	619.4
Mineral products.....	22.4	25.9	28.3	31.5	28.8	37.0	34.7	36.1	28.9	83.2	108.1
Iron and steel.....	9.4	15.3	13.3	19.3	13.4	26.3	14.0	17.5	14.9	35.6	57.4
Nonferrous metals.....	2.7	3.1	4.6	4.6	4.4	5.9	6.3	15.5	12.3	6.8	15.1
Metal products.....	10.2	12.9	14.4	16.1	17.0	23.7	25.1	28.6	28.1	33.1	32.1
Electrical appliances.....	4.8	5.8	5.4	9.8	12.5	15.3	18.7	23.6	17.6	16.2	25.7
Road vehicles.....	1.5	1.6	2.1	3.1	3.1	3.4	4.3	4.8	8.0	16.2	25.7
Furniture.....	7.0	9.3	8.2	11.9	11.1	11.1	10.7	13.0	9.6	26.9	36.5
Travel goods, handbags.....	1.9	3.6	4.1	5.0	5.0	6.4	7.0	8.8	7.6	14.5	21.2
Clothing.....	27.8	45.3	59.1	80.2	66.5	94.5	129.9	166.8	120.4	132.4	218.4
Footwear.....	4.4	6.6	8.1	11.5	8.9	12.2	15.0	18.2	14.7	17.2	30.5
Watches and clocks.....	1.4	3.9	5.3	6.5	6.1	9.2	16.8	20.3	16.1	1.5	16.9
Other commodities.....	1.6	1.7	1.7	2.3	1.5	1.7	4.3	2.8	1.9	6.3	7.3
Other commodities.....	1.6	1.7	1.7	2.3	1.5	1.7	4.3	2.8	1.9	6.3	7.3

¹ Data is from the Japanese Ministry of Foreign Trade and is slightly different from the IMF data which we use in tables 1-4. We have reduced the Japanese imports c.i.f. by 5 percent to reflect Chinese exports (o.b. Categories are based on the Brussels Tariff Nomenclature (BTN) which Japan uses. We will continue to use Standard International Trade Classification (SITC) nomenclature in the annual—2d quarter—edition that includes commodity detail of all Chinese trade.

² Data is from the Census and Statistics Department, Hong Kong and may differ from the IMF data used in tables 1-4. Categories are based on the Standard International Trade Classification (SITC) Revision 2. We will continue to use SITC Revision 1 in our annual 2d quarterly trade report that includes commodity data for all Chinese trade.

³ No trade was reported.

⁴ Trade was negligible.

Mr. SUTTER. Thank you very much for a very thoughtful presentation.

Our next speaker also comes at this issue of United States-China economic relations from a different perspective. This is John Hardt, who is the Associate Director for Senior Specialists and Senior Specialist in Soviet Economics at the Congressional Research Service. He also serves as adjunct professor in economics at the Institute of Sino-Soviet Studies at the George Washington University.

Dr. Hardt was educated at Columbia University and has had a long and distinguished career both in academic life and government service, as is seen from his list of publications.

Most of us in the China field know him very well for his work as the coordinator of the Joint Economic Committee effort on the Chinese economy that comes out every 3 years.

Dr. Hardt, please.

**STATEMENT OF JOHN P. HARDT, SENIOR SPECIALIST,
CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS**

Mr. HARDT. Thank you, Bob.

I think there is a good deal of commonality in the prepared statements, so I would like to pick up where Erland Heginbotham left and stress some of the differences in the alternative approaches of U.S. policy to economic relations with the People's Republic of China.

I would like to suggest three alternative strategies. One is what I might call a "preferential laissez-faire" policy, which is the one stressing the removal of obstacles from business activities, but stressing the role of business as a major actor, and the government as at best a subordinate actor in the development of policy.

The second might be called a strategy of "preferential partnership" involving the U.S. Government and the business community in a more integrated way, and in this regard I would like to suggest for some discussion as a focal point the consideration of a long-term economic agreement with China. The reason I suggest this is because of my knowledge and experience of the long-term agreement the Germans have with the Soviets, and I understand but am not too knowledgeable about the long-term agreement the Japanese have with China.

But this as an organizing factor might be an interesting formulation for considering the utility of a partnership in a preferential policy.

The third policy is somewhat different from that that has been discussed, and it comes particularly from my experience in Eastern Europe and the Soviet Union, and I would call this scenario a "constrained policy with safeguards."

In this regard I feel we should be concerned about the possibility that some of our projections may be, if you don't mind my using the term, euphoric or optimistic, or subject to reversal, and they may have unintended implications for other countries and our relationship in a multilateral context. Therefore, it would be useful to keep in mind in the sense of contingency planning that there is a great deal that may occur in the future that we might wish to have either in a partnership or laissez-faire context, a policy that would deal with a downturn in relations.

On this I am particularly sensitive to the Polish situation. Having been in Poland just before martial law, when our policy was still very

preferential and we had gone through a process of removing most of the trade obstacles that have been discussed here, we were left with a policy of going to sanctions; that is, a policy of limited options.

In my view, we were left with a policy that was not well-prepared and had limited options in terms of effective action. In that sense, although I don't suggest for the moment that China is likely to be another Poland, nonetheless we should learn from experience and plan for the possibility of worst as well as best outcomes.

In reference to the first strategy, this is referred to as preferential because it seems to me that we are talking about relationships with China that are preferential in the context of the relationship with other countries. For example, it at least implies to me not only removal of obstacles for Ex-Im Bank and other government facilities such as the Commodity Credit Corporation, but also a furling for these agencies, and I am not suggesting it is not appropriate, but in the present budget context this would indeed be preferential. In fact, I believe we have promised them a figure which is rather substantial in terms of Export-Import Bank credit, to be sure, by a previous administration, but I think there is continuity in our policy.

Now that, of course, is a hypothesis. [General laughter.]

In the sense of preferential, I think there is an argument for a preferential policy. The argument is that in some of the areas—and many of these have been developed, certainly the energy area, the variety of energy developments of coal, gas, oil, on-shore and off-shore, metallurgical developments, transportation projects, agricultural equipment—there is an argument, it seems to me, and I am just trying to pinpoint it here so that we can be sure we are talking about the same kind of argument, that in these areas there is a likelihood of continuation of an open economy, and even though the prospects now are not as great as they were expected to be, that at some time in the predictable future, for example in the 1990's, there may be substantial benefit to the United States, to the Western trading partner in being in on, encouraging, and facilitating the effective development in these areas, and that therefore it is worth the risk and it is worth the commitment to be in on the ground floor and to be able to participate in being competitive and benefit from them.

I think in a sense that was the point Mr. Holland was making in reference to off-shore oil. It is a high risk but high-payoff arrangement. Is that our policy? Perhaps it is. If it is, let's see how far it goes.

Now, in reference to a partnership, it has been said often around the table here that the economics and politics are interrelated. In fact, Mr. Heginbotham referred to this again in another context. It is very difficult to separate these factors. It is very hard for the important policy areas to be adequately dealt with by business. Separating business from the government may, in effect, separate the integral parts of a necessary policy of integrating the issues of political as well as economic development.

The idea of a long-term agreement, it seems to me, may be useful in terms of effectuating a partnership because not only would it help focus our interest on the national level but it also would focus us on the issue of information and study.

In reference to the information issue, I would suggest the format of basket II of the Helsinki agreement as some very useful verbiage.

I must say, knowing the statistics of Eastern Europe, they have a very unuseful compliance record, but nonetheless, were the kind of statistics available, information available that is prescribed by this agreement for China, it would be extremely useful in formulating a national economic policy and of relevance to particular industries and sectors.

It would also be useful to provide a forum within which the Chinese may be encouraged to develop better project planning themselves and better forward planning as well as integrated planning. It seems to me, reading some of the literature that I have been getting from various members that are in this room of projects and problems, the Chinese could definitely improve their long-term project planning and it would be of benefit to all concerned.

One could develop this question in the context of a long-term agreement further, but let me defer that to later discussion.

The process beyond normalization has been well developed, I think, by others. There is a road map. There is a long issue agenda for changing legislation, for changing through waivability restrictions that are possible under the legislation by administrative action, and if we proceed on one or the other variant of a preferential policy, it seems that this agenda is going to be extremely useful.

But when we consider increasing the economic capabilities of China, participating in them, it seems we also must keep in mind that this has bilateral and multilateral implications. In this sense, the implications for the Pacific area as a whole and the role that China may play, particularly as a stronger economic power in the military and political context, may deserve a good deal more attention.

If we have too much of a tunnel approach to bilateral relationships, we may find unexpected and unwelcome developments in a multi-lateral and regional context.

Thank you.

[Mr. Hardt's prepared statement follows:]

PREPARED STATEMENT OF JOHN P. HARDT¹

U.S. ECONOMIC POLICY TOWARD CHINA

I. Normalization to date

U.S. economic policy towards the People's Republic of China has gone through a process of change from near mutual isolation in 1970 to current "normalization." In this process we have jointly taken a number of steps:

1. Diplomatic recognition.
2. Bilateral trade agreement.
3. Extension of MFN tariff treatment.
4. Availability of Government credits.
5. Establishment of Joint Commercial Commission.
6. Establishment of Joint Trade Council (private).
7. Foreign business representation offices authorized and established.
8. Foreign equity investment with local partner authorized and utilized.

The PRC has also joined the International Monetary Fund and the World Bank (the IBRD). China's admission to these foundation organizations of the world monetary system further enhanced relations between the PRC and the United States.

Has the development of PRC-United States economic relations proceeded as far as our national interests dictate? Specifically, I wish to pose the following

¹ The paper draws on "East-West Commercial Policy: A Congressional Dialogue with the Reagan Administration," Joint Economic Committee, February 11, 1982, p. 73; "China Under the Four Modernizations," Volumes 1 and 2, Joint Economic Committee, forthcoming; "Pacific Region Independencies," Joint Economic Committee, June 1981, pp. 148.

questions: (1) Should we devote more resources to credit, representation, and other means of trade facilitation with the PRC than other trading partners? (2) Should we commit ourselves to a long-term economic agreement with specific commitments to particular projects? (3) Should we proceed to review the status of the PRC as a Communist power in the traditional adversarial mold of the U.S.S.R. and as a non-market economy subject to special legal constraints in bilateral trade?

Affirmative answers to these questions would suggest that we consider that the PRC merits preferential treatment as a trading partner, that the current changes in the political and economic organization of China are reasonably permanent—at least not readily reversible—and the important elements of China's national interests and system of government will be reasonably compatible with our interests over time. Let me deal with these points in three categories: China as a preferred market, modernization and normalization as irreversible Chinese policies, and coincidences of the interests of the United States and the PRC as international powers. From these assessments a policy agenda for the United States may be addressed. On it are three major questions:

1. Should terms of trade with China be preferential?
2. Should normalization proceed to change China's status as a Communist nation and state-controlled economy in U.S. law and policy?
3. Should our broader policies toward China and Asia be based on an assumption that the current United States-PRC common interests will be enduring or reversible?

II. China as a preferred market

The size of China—whether expressed in terms of population, land mass, resource endowment, or output—has made it an economic attraction to more developed Western economies for centuries. Recent Chinese plans for the development of petroleum, steel, and coal resources held out the promise of a closefit between United States and Chinese trade needs. But, these programs, which were launched with such promise in 1978, have been delayed or shelved for perhaps a decade. While China may look to the United States for grain, machinery and other manufactured goods, it now appears that trade turnover will be at a much lower level than anticipated by many in the United States just a short time ago.

In this slowly expanding China market, U.S. grain exports may be increased, but industrial equipment prospects are likely to be limited in the short run. In the short-term, the expansion of government credits (ExIm and CCC) would seem to be less justified on economic grounds, especially in a period of U.S. budget austerity. The United States may expect a positive trade balance if modest levels of soft loans are available from international agencies, but the PRC is not likely to be a major source of hard currency trade surpluses.

Will the PRC return to the ambitious levels of energy and material modernization that earlier held promise for U.S. trade? If we expect that it will, should we make special efforts now to encourage joint projects to make the United States competitive in the longer term, i.e. "to get our foot in the door"? There are few such large scale projects for the expansion of U.S. economic interests elsewhere in the world. The very magnitude of the Chinese prospects may merit special preference and attention. The lead times for iron, and non-ferrous complexes, harbors, railways, oil and gas fields, and coal mines might be well used for careful planning and project development to assure U.S. access to a burgeoning China market in the 1990's. A major deficiency in China appears to be complex project planning. The experience of the Boashan steel mill illustrates this point rather well. Indeed, one of the more positive aspects of the Soviet-PRC relationships of the 1950's may have been the Soviet aid in project planning.

At the same time, there are potential drawbacks to increased trade with China. In the short-run, increased trade would have to be based on rapid increases in Chinese exports of light manufactures such as textiles, which would cause problems for the U.S. domestic market in terms of market shares allotted to competing domestic producers and to other textile supplying countries such as Taiwan, Hong Kong, and South Korea. Moreover reliance on the Chinese market may not be wise for United States agriculture in the long term, especially for wheat exports as the PRC still appears to be committed to self-sufficiency in food production. It may be difficult for the Chinese to meet their long-run feed grain requirements from their own output, but food grain self-sufficiency is still apparently a long-term Chinese goal.

III. Reversibility of modernization and normalization policy

China's determination to modernize its economy on the course initiated by Mao's successors in 1977 persists. The drive toward normalization of China's economic relations with Japan, the United States and the other advanced industrial economies is resulting in a modestly increasing degree of interdependence.

However, the Four Modernizations program for modernizing industry, agriculture, science and technology, and defense has undergone considerable changes since it was announced with such fanfare in early 1978. Having realized that the program was much too ambitious, given China's current capabilities, the leadership is in the process of readjusting, reorienting and retrenching the Four Modernizations into something more pragmatic, realistic and attainable. The main lines of the modernization program still obtain, but the adjustment may occupy much of the decade of the 1980's:

Economic development is still the overriding imperative, but the reliance on costly major projects is being reduced at this time. For example, the mammoth, modern Baoshan iron and steel complex is being scaled down to a more attainable size.

Although implementation of economic reforms, such as decentralization of planning and the introduction of incentives continues, efforts have been made to retain necessary central control and economic stability.

Western systems and processes are still important, but the measuring rod for China's modernization is less the acquisition of the most advanced Western technology, but a more judicious blend of foreign experience and self reliance.

Improvement in living conditions is still an important goal, but any earlier U.S. expectation that China could rapidly move beyond meeting the subsistence requirements of its citizens should be tempered.

Uncertainty about effectiveness and permanence of the readjustment persists. Retrenchment may yet become reversal. Leadership changes may resurface at least some of the old ideological priorities evident during the Cultural Revolution and the Great Leap Forward. Likewise, the priority of the fourth modernization—that of the military—may rise and threaten the attainment of the other three.

The normalization of economic and political relations with Japan, the United States and other advanced Western economies continues to contribute to modernization. But, normalization has also been reassessed and readjusted by Beijing:

Western imports for major projects have been cut back in accordance with China's limited hard currency reserves and special technological requirements.

Institutions, legal systems, market practices are still in a state of flux. While some Western practices are emulated, they are also being adapted to China's special circumstances and needs.

Barriers to Western economic relations such as expropriation claims, political constraints, tariffs and credit restrictions continue to be reduced, but the full use of Western business and governmental banking facilities is pursued at a more measured selective pace.

Just as political stability is critical to modernization and normalization, readjustment of Chinese modernization and normalization is essential to political stability and economic growth in the PRC. Opportunities for Western exporters in the China market, business facilitation, financial mechanisms, and legal facilities all turn on the pace and character of modernization that underpin the benefits of normalization. Once again Western exporters have seen through the "oil for the lamps of China" mirage and adopted more modest expectations for new and profitable China markets. Chinese planners, in turn, have scaled down their plans to fit technical and financial possibilities.

Especially critical to the long term prospects of modernization and normalization are the continuity and stability of leadership views and perceptions. Can Deng's policies outlive him? Has he been able, or will he be able, to build up a leadership cadre that will maintain his economic policies? Bureaucracies have a way of frustrating or facilitating change or continuity. If one assumes that China's current bureaucracy has a stake in continuing modernization and normalization how may one test whether it has?

The low priority of military modernization has always been a puzzle to specialists on other Communist countries, especially the U.S.S.R. The Chinese military is an important and powerful group in Chinese leadership. The Chinese military is technologically inferior to its major neighbor, the U.S.S.R. If it were modern-

ized, China's relative capabilities vis-a-vis all hostile neighbors would arguably be improved. Why then is military modernization the fourth priority in the modernization program? To be sure, the massive Chinese standing army and limited nuclear force may serve as an effective deterrence to invasion. Perhaps that is judged sufficiently for China's current needs. Such assessments on the adequacy of military preparedness, if they are the official views, could change. Some Chinese military pronouncements seem to indicate some pressures to change. If the military becomes a more effective competitor for scarce resources, the modernization program for civilian industry and agriculture would suffer.

The selective revival of science and technology may be essential to modernization, but could hold potential seeds of popular resentment. Elitism vs. egalitarianism is not an issue unique to Communist China, but has been an especially divisive issue in the recent past. Meritocracy in education and job opportunity has engendered charges of discrimination in China, whether applied by a Confucian or Communist system.

Overarching all these questions of stability or reversibility is the question of Maoism. Did Maoism die with the great revolutionary leader? Were the reversals of the past economic policies during the Great Leap Forward and the Cultural Revolution changes that only Mao would and could dictate? Or is Maoism, as opposed to the tenets of modernization and normalization, indigenous to the Chinese Communist system? A hedge on reversibility would make U.S. policy commitments more tentative and cautious.

IV. Common United States-Chinese national interests

The People's Republic of China has moved toward a pro-Western orientation in some of its policy, toward an expanded role in Asian and global economies, and toward a position as a responsible Asian and, in time, a world power. Does the United States share these Chinese objectives? Should we encourage their fulfillment? If so, in what manner?

Where China stands is of very considerable moment to the United States and the world. China's increasing importance and possible implications of shifts in its policy give this set of questions a singular importance. Possibly no other nation will grow in importance as much as the PRC in the decade ahead. Possibly no other nation has the potential for such divergent scenarios of performance in the 1980's and 1990's. In the world power balance the United States plus China on many issues would be essentially different from the Soviet Union plus China on similar key issues. As vital as attaining the favorable equation may be, it is not attainable by all means nor should it be attained at any cost.

Reorientation of China.—If we determine that it is in our interest to play the "China card" as a means of countering the Soviet Union and, at the same time, to foster the modernization of China's economy and the opening of Chinese society to the moderating influences of membership in the community of nations, can we be sure that these goals are compatible? Is there a basis for a U.S. policy toward the PRC that nations with such diverse interests as Japan, South Korea, the members of ASEAN and India may share? What formal or informal economic steps might be useful to forge a common policy?

The "China card" approach to the Soviet Union has its dangers. If we assume that Chinese foreign policy, or military modernization is acceptable, or to be supported because it is opposed by or inimical to the U.S.S.R., we run the danger of encouraging policies that counter our own interests. We may not wish to encourage Chinese military modernization by making available equipment or processes with military applications. Military developments once undertaken may be difficult to reverse. The future use of Chinese military force can, of course, be difficult for us to influence or anticipate.

Other Western nations have reservations about our view of Chinese-Soviet relations and use of the "China card." They believe we are overly taken with the proverb that "the enemy of an enemy is a friend."

The Soviet Union, for its part, is extremely sensitive to our China policy. Every shift from an evenhanded policy toward the PRC and the U.S.S.R. is interpreted as a step on the road to full scale United States-PRC military cooperation. Even extension of CCC credits to the PRC before normalization was interpreted by the Soviets as a step toward a Washington-Beijing anti-Soviet alliance. While this Soviet concern may provide the United States with useful bargaining chips in some contexts, it may also exacerbate United States-Soviet relations in unintended ways that are inimicable to our negotiating interests.

China as an actor in the Asian and global economies.—If Pacific rim economic interrelations develop further toward a Pacific community, should we encourage the PRC to be an active member? In moving toward "normal" economic relations should we refashion our laws and policy away from the restrictions imposed on trade with other Communist countries?

We might move toward more active relations in the Pacific economic community. This role might be paralleled by encouragement of greater formal and informal relations between the PRC and the Pacific community. This poses the question of whether competitive economic interests outweigh cooperative economic interests for the Asian countries.

All of the Asian economies may find some fit between their economies and that of the PRC. However, since it is the predominant military power in Asia, the PRC might use economic interdependence for political purposes. Preventing what China perceives as Soviet attempts at Asian hegemony may be one political purpose. Restoring historical Chinese dominance over northeast and southeast Asian areas would be another matter. Reasserting the Mainland's control of Taiwan would also be a very sensitive matter. Economic issues such as competing claims to potentially oil-rich offshore areas might bring these issues into focus.

Chinese policy toward Japan might adopt a more overtly anti-Soviet tone. Depending on Soviet-Japanese relations on the Northern Territories, fishing rights and other issues, the Japanese might resist further movement away from their policy of evenhandedness.

China as a regional and great power.—If the United States continues to favor a unified, stable, and strong People's Republic of China, what Chinese modernization policies are in our interest? Should we, for example, encourage rapid industrial, agricultural and scientific and technological development through our political influence, economic aid, scientific exchanges, and other means? Should we encourage resolution of the Taiwan issue? If so, on what formula?

A modernized Chinese economy would provide a firm base for regional power influence. In terms of population and military potential the PRC casts a large shadow of power over Asia. After repairing its military weakness vis-a-vis the Soviet Union through technological progress, the PRC could well look toward joining the councils of Great Powers on a predictable time schedule. In that process of change some resolution of the Taiwan issue seems likely. The terms of change and accommodation would be of considerable importance to the United States. Asian economic interdependence would enhance the PRC influence in political affairs. Harnessed to a modernizing PRC economy by increasing economic ties, dynamic areas such as Hong Kong and Taiwan could have profound, albeit, different effects on mainland growth and reform and vice versa. Again the political conditions of such relationships would be important to U.S. interests.

V. Policy agenda

A number of central policy questions may be given further attention:

A. *Preference for China Market.*—In order to provide more government credits from the Export-Import Bank and Commodity Credit Corporation to facilitate industrial and agricultural trade a policy more favorable than that applied to most other trade partners would need to be adopted. The immediate prospects of the China market do not appear to merit this special treatment. Political and longer term economic prospects may, however, merit consideration of a special U.S. policy toward China. It might include business facilitation, reduced tariffs, and lessened restrictions on market access.

In the next 10 to 15 years, the United States may have the opportunity to participate in cooperative projects with the Chinese in the following areas:

1. Metallurgical developments (iron and steel, nonferrous metal production and processing)
2. Transportation projects (harbors, railways)
3. Energy developments (coal, gas and oil, including offshore)
4. Agricultural equipment and supply (machinery, fertilizer output)

A formal U.S. study of these prospects might provide insights on their promise, feasibility, and likely profitability to the United States. If this assessment were favorable, it might provide a basis for current policy preference based on future gain. This also might be the key element in a possible long term United States-PRC economic agreement. Such an agreement could facilitate establishing the institutional framework for a privileged or equal U.S. competitive position in the China market of the future, depending on whether competitor's did the same.

B. *Beyond normalization.*—The United States has normalized trade relations

with the PRC as well as with Yugoslavia, Poland, Romania and Hungary. Beyond normalization we might consider treating the PRC as a country not covered by the traditional legal constraints of "Communist country" and "state trading economy." In that case, exports to the PRC would be less restricted even for dual use technology that might have military applications. If the PRC were considered "state influenced" rather than "state-controlled," our restrictive anti-dumping legislation would not apply. In taking such steps beyond current normalization we should consider how reversible the basic Chinese political and economic policies are. Any legislative and policy actions we take should leave us appropriate flexibility to respond to change.

The removal of some of the remaining restrictions on trade with the PRC would require legislation. In some cases in which U.S. law requires restrictions, the Administration may ask Congress to waive them for China. Other restrictions may be loosened or modified at the discretion of the Executive.² Restrictions falling into these three categories are summarized below:

Restrictions requiring legislative action for removal: This category includes: the market disruption provisions of Section 406 of the Trade Act of 1974, which apply only to imports from Communist countries; the mandatory inclusion of safeguard clauses in bilateral trade agreements; and the alternative method of determining the foreign market value of imports from state-controlled-economy countries in anti-dumping investigations.

Restrictions required by law, but waivable by legislation: The major restrictions in this category are: the ban on Communist country participation in Export-Import Bank programs and the Jackson-Vanik Amendment to the Trade Act of 1974, which establishes freedom of emigration as a prerequisite for granting most-favored-nation tariff status. In the case of China, these requirements are by-passed through a waiver, which must be renewed periodically.

Restrictions subject to the Administration's discretion: Since controls on exports of equipment and technical data are based on legislation that authorizes rather than mandates Executive action, they may be loosened or removed at the discretion of the Administration. Further liberalization of controls on exports to China is possible through relatively simple administrative changes.

C. Continuity of Common Interests.—Assuming some continuing bipolarity and the adversarial nature of world politics, we should be assured that the PRC will not realign itself with the Communist nations led by the U.S.S.R. Yet, even without rapprochement between Moscow and Beijing the PRC may find considerable common cause with the Communist nations in the Soviet bloc. Moreover, before proceeding with relations with China we should be aware that the PRC can play the "American card" with the U.S.S.R. and other Communist countries. Indeed, the common understanding in our relationship would not prevent China from playing the "American card." Nor is the Soviet Union excluded from using its relationships with the PRC in its relations with us.

Mr. SUTTER. Thank you very much, Dr. Hardt.

We certainly have a full agenda for discussion among our participants here, but before we do that, because of the way we set up, I think the only way we are going to be able to get coffee is to make a lot of noise, so why don't we take a break until about 20 minutes to 11, and then after we have had coffee, which should be outside the door, we will come back and resume our discussion.

[A brief recess was taken.]

Mr. SUTTER. Ladies and gentlemen, please take your seats.

Senator Hayakawa has joined us and would like to make a brief statement.

Senator HAYAKAWA. It is one of the appalling disadvantages of my job that if I don't have to be three places at once, I at least have to be two places at once, and I had to divide my time this morning between the Small Business Committee, where I am discussing the problems of the urban enterprise zones, at the same time as I should

² Formulation of these issues by my colleague Vladimir Pregelj of CRS was most helpful.

be here, so you will forgive me if I run back and forth between the two.

I am giving you now my closing remarks. In my opening remarks I said I was having some difficulty adjusting to our new relationship with China and I had some reservations about how the United States should proceed in that relationship. Although I have not been able to be with you for the entire time, the time I have spent with you, together with the staff's reports of your discussions in my absence, have been most reassuring to me.

All of you seem to be realistic about the prospects of expanding our economic relations with China, and all of you seem to be fully aware both of the advantages and disadvantages implicit in such relationships. Looking at the question from the Chinese perspective, your assessment seems to me a conservative one, supporting the view that a remarkable expansion probably is not possible or desirable from their immediate point of view; however, opportunities for American business do exist and should be taken advantage of.

These conclusions strike me as sensible. They are worth noting. They are worth publicizing. Furthermore, I believe that a major contribution of this seminar will be to dispel some of the euphoria surrounding the vast China market of which I spoke earlier, while pointing the way for U.S. business in a more realistic manner. As Mr. Lubman has said, euphoria is a cheap export.

I thank all of the participants for their very important contributions. I was most interested to note that, as one of the discussants commented at some length, it is very difficult to predict the future of the Chinese economy. There was also some discussion of budget deficits, unemployment, and inflation in China, so despite the differences between their socialist and our capitalist systems, we do have problems in common.

I gather that the consensus is that the greatest opportunities for American business lie in the field of oil exploration but that even in this area it is too early to say how large an American investment might be called for. Uncertainty about the political stability of China over the next generation certainly will play a role in our decisions.

Aside from the petroleum area, it would appear that you foresee only marginal improvement of productivity of Chinese industry in years ahead.

Finally, I think the questions which have been raised about doing business in China, about the complexities of dealing with decentralization and competing agencies and about the need for a long-range approach to doing business in China or with China, as one of our speakers mentioned, will be very helpful to American businesses in years to come. Among the rules of thumb which have been mentioned, Mr. Lubman's stands out. He urged, I believe, patience and a sense of humor.

One of the great difficulties about our relations with China is they have been carried on under a cloak of secrecy. From the time of the Nixon administration when Dr. Kissinger made the highly secretive flight from Pakistan to Peking, through the Ford administration to the Carter administration and the surprise announcement of normalization of relations and on to the present administration with its announcement that it is prepared to consider the sale of lethal military equipment to China, the American people have been confronted with a series of *faits accomplis*.

There has been no significant national debate over the merits or demerits of our expanding relations with China. In the volume of legislation which the Congress has enacted in the decade since the Shanghai Communique, there are almost no votes recorded reflecting the views of Congress on China. The recently ratified Chinese Consular Convention is the one obvious exception.

This is not a healthy way to conduct the foreign affairs of the United States. In the past day and a half you, the participants in this workshop, have made a major contribution toward the national debate which is so badly needed. We shall do everything in our power to publicize your contribution and to encourage further debate. Only in this way shall we know what is truly in the U.S. national interest and what the American people want their Government to do as that relationship matures.

As I said at the close of our earlier seminar last fall, it is clear that we have not settled all the issues raised here, but it is important, in my opinion, that they have been raised, they have been discussed, a dialog has been started which should be continued in Congress itself, in the executive, in the media, in academic circles, in the business world, and in many other public forums.

For your contributions to the process, therefore, I wish to extend my very sincere thanks and appreciation. I want to thank Dr. Robert Sutter of the Congressional Research Service for chairing this seminar during my absence as well as for organizing it so well. Dr. Sutter you and the committee staff are to be commended for the arrangements you have made so successfully.

Now, let me go back to my original point. I do regret that I cannot remain here any longer. I must go back to small business and see to it that it doesn't remain small forever. [General laughter.]

I shall ask Dr. Sutter to resume the chair, and I shall look forward to reading the entire report of your deliberations. Thank you again, all of you, and thank you, Dr. Sutter.

Mr. SUTTER. Thank you, Senator.

Before we begin our discussions of the issues raised this morning, we have one other person who would like to make a presentation. This is Robert A. Cornell, Deputy Assistant Secretary for International Trade and Investment Policy in the Department of the Treasury. Mr. Cornell is a career civil servant. He was appointed to his current post a few years ago, and he came to that post from the General Services Administration where he served as an Assistant Commissioner.

Mr. Cornell, many of the issues that we have discussed both yesterday and today have related to issues that are relevant to the Department of the Treasury, so we appreciate your willingness to come and to offer some remarks to us.

Mr. Cornell, please.

STATEMENT OF ROBERT A. CORNELL, DEPUTY ASSISTANT SECRETARY FOR INTERNATIONAL TRADE AND INVESTMENT POLICY, DEPARTMENT OF THE TREASURY

Mr. CORNELL. Thank you very much, Bob. I do not have any prepared statement but I promise I will not run overtime. I am speaking in a reactive mode to the presentations that were made this morning, but there is a thematic structure to what I have to say. To

go back to the broader question, what is, not so much the proper, but the feasible role of the U.S. Government in the development of United States-China economic relations?

To refer to something that was said a few minutes ago during the regular presentations, there is a question of continuity of policy between administrations. I think it is necessary to say that as administrations change, especially when there is a fairly radical change ideologically such as that which occurred in the last elections, one can see evidences of a lack of continuity.

That is not necessarily true however. If you ask what can governments do and what can governments not do in a particular kind of a situation, I think you will find continuity.

The main point that I would make is that at least from the viewpoint of the present administration, if there is to be a surge in economic exchanges based on trade and investment between the United States and China, that surge is going to come from activity of the U.S. private sector, in the context of institutional arrangements it can put together vis-a-vis the Government of China, which of course does not have a private sector in the same sense as we do.

This is a point that was made clearly and quite forcefully to the Chinese by Secretary Regan last November at the annual meeting of the United States-China Joint Economic Committee, to which I will return in a minute. The point was made that governmental institutions, like the Export-Import Bank, the trade and development program, or OPIC, would not be the funnel through which huge amounts of investment capital and the like would flow into China. We had to say that that was not where the prime source of capital could come from, from the United States.

Our system just is not oriented to using governmental institutions in that way. Rather, if the Chinese wished to tap the resources that are available in the United States or in the West in general, they would have to tap them through the private sector. One idea, for example, which arose in these discussions was the creation of a joint venture investment bank in China through some Chinese institution, be it the Bank of China or another entity and a private sector organization or consortium of private sector organizations in the United States.

It was an idea that attracted the Chinese. It certainly attracted us and it is something that we are following up.

Now, given that basic premise that real Chinese access to the benefits of trade and investment vis-a-vis the United States depends upon private sector activity, where does the Government fit in? Well, the Government fits in, in some very traditional ways because the opening of relations with a country like China, with which we have not had relations in the recent past is, a *de novo* thing. Therefore, what we need to provide are basic traditional standard facilitating mechanisms that are within the powers of government to organize, simple but important things like maritime agreements, aviation agreements, and the management of trade within the context of global trade policies.

Regarding trade with China I better point out that already we are beginning to encounter some of the same kinds of problems we encounter with other countries. Think about wool sweaters. The U.S. market got inundated with Chinese wool sweaters about a year ago and a trade policy action was taken because there were protests within the domestic industry. That old bug-a-bear showed up again, as it does whenever we open up relations with any country.

I think that those who look to the Chinese market as a source of new business need to be aware of these kinds of problems because governments, react to pressures from their private sector, at least the U.S. Government does. I think that the U.S. business community should have a clear understanding of potential issues lest the people who are exporting and investing discover all of a sudden that the Chinese take the perfectly logical and indeed justifiable step of insisting upon two-way trade. At that point you will find an importer in the United States who will start complaining about Chinese textiles or other Chinese imports and insisting that brakes be applied.

Thus there are diplomatic, political, and economic problems that develop between countries. So to the extent that the U.S. private sector can have a unified approach to the development of economic relations, I think some of these questions can be blunted. Nevertheless, it is both within the power and responsibility of Government to deal with those kinds of issues.

Another area discussed yesterday, which is very much a governmental matter, is the area of tax policy. The Chinese have completed their basic tax law. They have had discussions with the U.S. Treasury and other tax experts about their tax law, given their own domestic constraints on what they want it to do and how they can frame it in such a way that it does not preclude the possibility, for example, of creditability of earnings against U.S. taxes.

In addition, both governments have initiated negotiating a bilateral income tax treaty which will gather more force and steam as time goes on. This is another area in which the Government operates.

Let me conclude. Within the U.S. Government, really, unlike our relations with most other countries of the world, there is a mechanism through which we try to manage all of these different areas of government involvement and economic activity with the Chinese.

That mechanism is the United States-China Joint Economic Committee, which is, at least structurally, not unlike the joint commissions that exist with most of the other nonmarket economy countries. We have one with the U.S.S.R., we have one with most of the Eastern European countries. But because we are starting *de novo* with the Chinese, the United States-China Joint Economic Committee is a little bit different and the Chinese look upon it as a very useful mechanism as well as the United States which devotes the time of Cabinet ministers to its annual meetings, with a lot of preparation and followup in between.

On the U.S. side, the committee consists of representatives of all the major governmental agencies that have economic contacts with China, which is Treasury, Commerce, State, USTR, the National Security Council, OPIC, the trade and development program, the Eximbank, and other interested agencies.

The momentum, behind the JEC is a series of annual meetings held between the U.S. group and a counterpart group from China with cochairmen, one being American one being Chinese. The Treasury Secretary chairs the U.S. side. A Chinese Vice Premier is the head for the Chinese side.

Between annual meetings the U.S. side of the JEC holds periodic sessions whereby we can keep track of and coordinate what the various U.S. Government agencies are doing in between the meetings and getting ready for the next one. This way we have some centralized

place where information is exchanged all throughout the Government and a sense for what is happening, for example, in the tax area, in the export-import area, in the investment guarantee area, just to name a few.

Having now been through two JEC meetings, one in the Carter administration and one in the Reagan administration, I find this is an extremely useful mechanism. I sense that increasingly the Chinese are beginning to ask much more practical questions and look to more practical business-oriented discussions as we move on from meeting to meeting.

The 1980 meeting was very festive and ceremonial, with the President signing numerous bilateral agreements and with a lot of generalities being spoken on both sides. The meeting last November was much different because the focus was now really starting to shift to issues of how the U.S. economy can interface with the Chinese economy in ways that will be acceptable to the Chinese given their basic economic policy thrust and in ways which will be facilitatable by an administration which is very private sector oriented.

So I hold out a considerable amount of hope. We are trying very hard in this administration to keep the process going and not let it degenerate into a frenzy of activity to get ready for each annual meeting and then have nothing for the next 11 months.

I recommend that you watch the activities of the JEC because they play an important part in United States-China relations.

Thank you very much.

Mr. SUTTER. Thank you very much. Let me ask Ms. Locke to begin the discussion.

Ms. LOCKE. Thank you.

Roger Sullivan proposed that Congress change laws so that China can become eligible, or that it no longer be prohibited, from receiving foreign assistance or Public Law 480 food for peace, at a time when the U.S. Government, as far as I know, is not contemplating sending aid to China.

My question is one really of timing. Should we go through an "aid to China" debate in the U.S. Congress, with all of the negative aspects that might be included in that debate, at a time when we really do not have a specific program that we want to engage with China? Should we make it one of those votes, one of those very few and unique votes that Senator Hayakawa talked about, on the United States-China relationship at this time? Or would your advice be to wait until we actually have a justifiable program that the administration does want to begin with China either in Public Law 480 or in the foreign aid area, and then use the normal authorization process to change the law so that we can proceed with that particular program with China?

It is a question really of how we address the issue, and at what time we take it up.

Mr. SULLIVAN. I guess I should give at least an initial response. Yes, you are quite right. It is a question of tactics, and far be it from me to try to tell staff how to plan the tactics of this complicated thing.

Let me make a couple of very simple points. One is, I think, yes, this should be done. Let me come back to my two basic points. One is the symbolism of this, the fact that the trade agreement between

the United States and China commits the United States "to undertake all appropriate measures to create the most favorable conditions for strengthening in all aspects the economic and trade relations between the two countries, so as to promote the continuous long-term development of trade between the two countries."

As I mentioned, we are 10 years from the Shanghai Communiqué, 3 years from normalization of political relations, and 2 years from the date this trade agreement went into effect, and it is an unnecessary souring of the relationship it seems to me, to have on the books provisions in law which in effect put the Chinese in the category of the Soviet Union or the Warsaw Pact.

On the question of flexibility, it seems to me that the U.S. Government unwisely ties its own hands, to have to wait until the point when it wants to do something to then go through the long procedure of giving itself the flexibility it needs to go ahead on Public Law 480. We already did have a case, and the people in the Department of Agriculture have told me they would have preferred to have that kind of flexibility, when the earthquake occurred in China but they didn't. Therefore, they had to scramble around, and finally found a way to contribute food aid to China through the world food program in Rome. But they could not move directly, and it would have been advantageous, they think, from the standpoint of protecting our agricultural markets, to have had that kind of flexibility.

I would just add one caveat. If the thrust of your question is that this would be a risky debate, I would caution that were we to take up any of these issues, were we to take up the question of whether we repeal Joe McCarthy's slap in the face of 1951, and then lose the vote, then my argument about symbolism becomes much more dramatic indeed. I mean, the damage to the relationship obviously would be severe. So, if any of these questions are going to be raised, I certainly would advise that unless these impediments and symbolic impediments to the relationship are going to be removed by the process, then we should not even attempt the changes.

Ms. LOCKE. Well, of course, nobody knows how a vote is going to come out until a vote is taken, but we can be sure it would not be uncontroversial. Foreign aid to China would be a major debate. The question is: Do you bring it up now, or do you bring it up in the normal procedure when the administration has a program, wants the money, and comes to Congress and asks for the money? In the latter case, Congress could include in the debate that particular project, rather than debate foreign aid to China in a vacuum.

Mr. SULLIVAN. Well, my argument would be that you don't have to debate foreign aid to China. I am not a tactician, but it would seem to me if you are addressing the question of our obligations under the agreement to simply get rid of these anachronist measures in American law, and you say we are not proposing a massive aid program to the Chinese, Congress is not being asked to vote on that. If anybody decides later that it is in the interests of the United States to consider an aid program to China, the Members will have to consider that on its merits.

But let's just take the simple symbolic step. Again, of course, I would defer to you.

Ms. LOCKE. Are there others who would have advice for Foreign Relations Committee members on this particular issue?

Mr. SUTTER. Mr. Lubman and Mr. Heginbotham would like to make remarks on this issue.

Mr. LUBMAN. Not on this issue.

Mr. SUTTER. Mr. Heginbotham.

Mr. HEGINBOTHAM. Yes. If I may, I would like to respond to this point, and also address a proposition that Dr. Hardt put when trying to relate the two. Let me begin with Dr. Hardt's remarks, and then reach Mary's point.

Dr. Hardt provided some very useful alternative strategies. What struck me as he was talking was that his strategy 2 and strategy 3, depending on how you define strategy 3, need not differ. His second strategy was a preferential approach, a kind of team-work relations between government and business. Strategy 3 was cautionary: "How do you hedge against possible deterioration in bilateral relations?"

One of the things that strikes me as I look at the relative positions of the United States in China and in the world is that we are poorly positioned in cautionary protection for American business. For example, many industrial nations provide special kinds of tax assistance to highly risky kinds of international business. For example, some countries provide, in precaution against possible losses, for accumulation of tax-deductible loss reserves.

There are a number of possible forms of government-aided protection in this area, where, as a general matter we are disadvantaged vis-a-vis the competition.

Now, what you might consider, Mary, are measures which could be of general worldwide advantage to American business vis-a-vis the competition, which can also aid American business in China. That approach would address problems such as high-risk undertakings—and certainly China qualifies in that area. It would be a way of addressing at least some—although not some of the more dramatic—points that Roger has addressed. As a more generalized response, they would not risk objections of being China specific.

Mr. SUTTER. Mr. Woodard, and then Mr. Cornell.

Mr. WOODARD. I think Mary Locke's point is very important in terms of timing, and whether you handle these things as a package or whether you break it down and deal with Public Law 480 in a different context than you deal with the aid and assistance issue in other areas, and so on.

It seems to me very important to underline the need for reciprocity at each stage of the game, when we are dealing with the Chinese. We are still faced, for example, in doing business with serious visa restrictions on the other side, where it takes us a month, unless you are doing business on a regular basis, or unless you have a registered branch in China; it takes the new firm and the new company that is coming down the line, and a lot of the support and equipment companies now are caught in this box, such as the petroleum industry; it takes the company a month to get a visa, because they have to go to the petroleum industry to get an invitation, in order to present that invitation to the consulate in Houston, to obtain the visa.

That is not normal visa procedure, and it is restrictive and damaging to our people doing business in the PRC.

I think we have pressed for reciprocity. As we take down the barriers, we must make sure that they take down the barriers, too. So I would

say the matter of timing and how we stage these things is in fact terribly important.

Mr. SUTTER. Mr. Cornell.

Mr. CORNELL. Thank you. I would like to come back to a point that Mr. Heginbotham raised in his last comment. It has to do with investment policy. There are very interesting and fascinating possibilities here, as I see U.S. investment policy evolving. It really has to do with our global policy, and the potential for making arrangements with China that can be a model for the rest of the world.

What is that we are coming to realize not only in the United States but in the other Western countries that investment flows are substitutes for investment that maximizes the influence of the private market, eliminates to the extent feasible and possible the distortions that can result from host country investment policies, and therefore will leave us with a model that we can carry to the Mexicos, Brazils, and Canadas of this world and say, "Hey, look, see how advantageous this is?"

I think this is a fascinating and interesting possibility, and is one reason why I think we need to be very interested in how we deal with the Chinese.

Mr. SUTTER. Thank you, Mr. Cornell.

It is 11:20. We originally had hoped to close at 11:30. I think if we could impose on our group here we could perhaps stay until quarter to 12 or even until 12, but in the interest of time, may we keep our comments fairly short?

Mr. Lubman, Mr. Lardy, and Mr. Sullivan wish to speak. Mr. Lubman, would you like to address the issue that we raised on the aid question?

Mr. LUBMAN. No, but I would like to speak to a theme that has emerged; that is, Mr. Hardt's discussion of extending preferential economic treatment to China, if that would be acceptable to you.

Mr. SUTTER. That is fine, but Mr. Lardy, do you have a follow-up question about what we were talking about specifically?

Mr. LARDY. Yes, my comment was on a question that Mary Locke had raised.

Mr. SUTTER. Let us address that issue first.

Mr. LARDY. It is very brief. I would separate out the Foreign Assistance Act and the Agricultural Trade and Development Act, from the other obstacles. It seems to me that the other obstacles, the Trade Act of 1974, those having to do with the Export-Import Bank, those having to do with the "Seven Deadly Sins," et cetera, are of immediate practical importance, and might be dealt with in a way that would remove both the symbolic and the actual impediments to trade relations with China.

I think that changes on the Foreign Assistance Act and Agricultural Trade and Development Act are much more complicated, and I would be sympathetic to the view that they really should not be changed until there is a specific proposal and a specific agenda for development assistance to China, and that the changes in legislation be specifically addressed in that context.

I think that change of legislation without a specific set of proposals raises a whole set of thorny issues that have no immediate payoff. Second, it might raise expectations on the Chinese side that in fact some large aid programs or Public Law 480 and other sorts of Govern-

ment-financed credits were going to become available. I think one of our problems in the past has been that we have, not intentionally, I don't believe, frequently led the Chinese to believe that more aid would be forthcoming in a variety of areas, than in fact we could provide.

I think Vice President Mondale's speech in Peking is the best example. We have not delivered on the Export-Import Bank credits that he promised.

Mr. SUTTER. Please speak up a little bit.

Mr. LARDY. I think we would be making the same sort of mistake if we introduced changes in the legislation on the Foreign Assistance and Agricultural Trade and Development Acts without specific or significant follow-on programs. So, I would recommend the separation of the Foreign Assistance Act and the Agricultural Trade and Development Act from actions on the other matters.

Mr. SUTTER. Mr. Lubman.

Mr. LUBMAN. A number of other people already have addressed themselves to John Hardt's provocative set of alternatives. I would like to interject another notion that I think is related to the idea of establishing a preferential economic relationship. I am deeply concerned that the relationship between economics and politics which we have talked about may blur some of the subtleties that should be applied in analyzing the situation. I refer specifically to the spillover into United States-Chinese negotiations of the policy that some in the administration have asserted toward the Soviet Union.

Specifically, I have in mind what I believe to be the expressions of dedicated ideologues who may be very sincere but who express what I perceive to be a very narrow view of United States-Soviet relations. For instance, Assistant Secretary of Commerce Lawrence Brady recently made a speech in San Francisco in which he took a very hard line against expansion of economic relations with the Soviet Union. In that speech, he adverted to China, and he said the United States sought to cooperate around the world with China in its opposition to "hegemonism", which of course the term used by the Chinese to refer to what they perceive as Soviet aggression.

I am deeply concerned at what I take to be the lack of subtlety and the lack of nuance in that kind of view. It amounts not only to a playing of the China card, but to a brandishing of the China card, to a stamping about and waving of the China card, which I think does violence to the necessary subtleties of the policy which John Hardt suggests when proposing consideration of a preferential relationship with China.

Second, with respect to preference, I would say that I agree with him that there should be mutuality; that is, a willingness on the part of the Chinese to discuss the extent of preference which the Chinese will give to the United States. That has some very deep implications for our trade policy. We might say to the Chinese that we would be glad to supply certain products and technology, and would like them to prefer us in certain instances, while we would reciprocate by buying the light industrial and textile products which China is now beginning to export in large quantities.

That raises an issue which Mr. Cornell mentioned, to which I adverted yesterday. It is one matter to express that willingness in

the abstract, but it is quite another to exclude clothespins, as was mentioned this morning in the New York Times or canned mushrooms, textiles, and the like. Mr. Cornell adverted to the case of woolen sweaters, and there is, I think, a respectable body of opinion (among importers, presumably) which argues that the whistle was blown on woolen sweaters too early. Obviously, that is an importer's point of view.

I think there are implications for our general trade policy, and for the policy that this country will follow on the impact on U.S. industry of cheaper good quality imports, whether from China or elsewhere, that must not be forgotten in the debate on trade treatment we should give to China.

Mr. SUTTER. Mr. Sullivan, please.

Mr. SULLIVAN. I have a brief comment, on the question of reciprocity. Certainly this is a matter of great concern to the American business community, and reciprocity should indeed be pursued in the areas where this is appropriate. But the kinds of restrictions I am talking about on trade and economic relations with China don't really seem to me to fit into that category.

The assumption is often made, because of the short hand way in which we talk about trade matters, that imposing a restriction on export trade penalizes the foreign country, and removing the restrictions rewards the foreign country. We talk about the way China is going to be treated for export control purposes. This is shorthand. The people who are being treated are the American business community. When you talk about restricting trade, you are restricting us. Just as when you say to the farmer he can't ship wheat, you may be penalizing the Soviet Union, but you are also penalizing the farmer.

It is very important for government to think this through, that if you are going to penalize the American business community, if you are going to penalize the American farmer, you had better know what you are doing. You had better have balanced out the advantages and disadvantages of that. In fact, in some cases, the other side isn't even penalized at all. When you say to an American firm that you can't sell software to China, and the Chinese turn around and buy it from Japan, who is being penalized?

Mr. SUTTER. Mr. Heginbotham and then Dr. Hardt.

Mr. HEGINBOTHAM. I would like to make a procedural suggestion, because I have found the past day and a half very stimulating. I believe the number of suggestions that have been made with regard to policy are interesting. I also believe that if the report is simply disseminated as a report, it may lack the impact that a real dialog on these recommendations would have.

I realize that the Congressional Research Service is not an arm of the executive branch and does not normally play a role directly vis-a-vis the executive branch, but it occurs to me in light of what Secretary Cornell said, that it might be terribly useful if the CRS could find a similar type of sponsor in the executive branch, and jointly arrange an opportunity for discussion of these policy recommendations with perhaps members of the administration's Joint Economic Committee on China. An opportunity to exchange views between members of the legislative branch and the executive branch on important policy issues certainly cannot hurt, and might generate a better understanding of these policy recommendations.

Mr. SUTTER. Thank you. Dr. Hardt, please.

Mr. HARDT. I would like to continue on the line of Mr. Sullivan a bit. When we talk about aid, as Mary Locke raised the point, we very often are talking about facilitation of exports, and it would be better to put it in that context. When we supplied corn to the Poles before martial law under Public Law 480, it allowed them to pay for the corn in zlotys, but it also allowed Illinois farmers to sell corn that was exported to Poland, and therefore benefited the income of American farmers, and so it goes with all of the various activities we are involved in, whether it is guarantees or Government credits, or whatever kind of facilitating action we take.

It stabilizes the market. It improves the market. And it is not just a matter of obscuring what goes on. It is a definite benefit to U.S. banks, to U.S. exporters, and perhaps it would be useful to put this in the broader context of what is our long-term strategy.

I did suggest a long-term economic agreement, because this is a way of looking at it, and talk in terms about how we can facilitate U.S. exports reaching their potential. Now, in that sense, some of the legislation, as many of us know well, uses the term of competitiveness, and that is what the justification of the Export-Import Bank loans are often based on. So, in a way, we are providing guarantees. We are providing resources in order to make U.S. firms competitive, and we tie them, and that is another important aspect, we don't allow them to spend our resources in Japan, we tie them to an American market.

Those points, I think, would be more than just tactical. They would be realistic and appropriate ways of packaging such a program so that we in effect could say there is an attractive way of generating U.S. jobs and production, to use some key terms, and that is to develop a market which is in our interest.

I must acknowledge that I use the term preferential for provocative purposes. What is discriminatory and what is preferential is in the eye of the beholder, but nonetheless it did, fortunately, provoke the kind of response that I thought would be useful. Thank you.

Mr. SUTTER. Let us open this up for general discussion on the floor.

Mr. FRIEDMAN. I am Ed Friedman, House Subcommittee on Asia staff. If I may associate myself with the thrust of Roger Sullivan's remarks in this discussion, first, it is true that if the negotiations now underway in Peking on the question of how to reach a set of principles which both sides can live with on the question of arms sales to Taiwan does not reach a successful conclusion, that much of this discussion here may be a nice academic discussion, and I really do think that that is the thing which is of first importance.

But after that, and assuming that that goes well, which may turn out to be a false assumption but assuming it goes well, in that case, one has to first have the facts straight. If one says that one wants to allow Export-Import Bank loans as a matter of course, even above \$50 million, that happens to be tied to the Foreign Assistance Act. The list of countries that are excluded from that as an ordinary course are the list of countries which are found in what used to be called section 620(f) of the Foreign Assistance Act. So unless you change the Foreign Assistance Act, you do not have that ordinary course of business under the Export-Import Bank. That is just the way the law happens to be written, and so if you want one, you must do the other first.

Second, I think it is a matter of politics and economics that if you have a situation where people in politics on the Chinese side, who have committed themselves to the American relationship on the promise that these negotiated agreements will be fulfilled, full economic normalization and so on, and they are embarrassed within Chinese politics, that makes it more difficult for them to deliver these other kinds of goods, and you are guaranteeing yourself a much further irritant on these other kinds of relationships. It is not again an academic question. You are involved, I assure you, in very mean politics in Peking as result of this.

And finally, on the economic side, as has been stressed, the debate you are actually in on economic aid to China is a debate that came out in the first discussion of the panelists, a very wise debate, which was which way you were going to facilitate American business through a small aid program. The consequence of not having any is to have people in Peking who are making agreements always be able to say, but the Japanese have made the contract sweeter, basically, and the United States hasn't done certain things, and so if you have something close and competitive, the question will always be raised, why go the American way?

There may be strategic reasons why, by the way, but in terms of pure economics, that won't be there. So the basic question is whether the United States is seriously interested in the full benefits of its relationship with China. If it is, if it believes those benefits exist, then I think we have a very large stake in continuing and fulfilling the economic normalization with China.

Mr. SUTTER. Thank you very much.

Ruth Goldberg has a comment to make.

Ms. GOLDBERG. I would like to change the conversation a little and go back to what I consider to be the general characteristics of the types of problems that we have with China, based on the different levels on which we interact with the Chinese.

I think we have done a very good job of noting most of the problems, and in many areas these levels overlap, but I think it is useful to see what these different levels are. First of all, we interact with China as China, with all of the quirks and characteristics of a volatile, uncertain market that we are just now becoming familiar with. In this area, the question of reciprocity that Kim Woodard raised, I think, is a major problem, and should be addressed in these China-to-China relations. These would be, for example, the kind of business facilitation issues that Dave Denny raised, visa problems, patent problems, office space problems, and that sort.

On the next level, we have to deal with China as a large and emerging developing country. This is not something that was discussed very much by the participants so far. We, as well as all the other industrialized countries in the world, have to recognize that it is in our interest, to see that China's continued participation in the international economic community is in our interest, that China sees that it has a stake in the same kind of world that we live in. We need to recognize that our welcoming them into international institutions is ultimately in our interest, and promotes China's participation and contributions to these institutions.

This is something that we have to deal with not only in the international institutions such as the IMF and the World Bank, but also

in bilateral protectionist issues, such as textiles, tungsten, and the other protectionist issues that are raised. The industrialized countries and the United States need to recognize that a certain amount of rejuvelling of international resources to welcome China into the real world is in our interest.

The third set of problems would be the ones along the line that Erland Heginbotham was raising. Those are the ones that are not specific to China, the problems that face all U.S. business in international trade, problems that are peculiar to the United States in terms of the kind of support that the U.S. Government provides to its business. To some extent a lot of the changes that need to be made are along the lines that Roger Sullivan was saying. That is, removal of impediments. There are definitely areas where the U.S. Government can play an active role in helping American companies do business outside of the United States.

The fourth area is that we treat China as a Communist country. This is reflected both in the fact that we have protections in our law against nonmarket economies, economies that are not like ours, which create a whole different set of problems from those that we face in trading with economies that are much more similar to our own.

In addition to that, we face restrictions from the 1950's which Roger Sullivan was talking about, everything from the "Seven Deadly Skins" to the Foreign Assistance Act and Public Law 480. To a large extent, it is these last sets of problems and inhibitions, those based on our view of China primarily as a Communist country, which concern me the most, because the United States is unique in these particular sets of problems. The other industrialized countries do not have the same sets of restrictions and the same kinds of psychological responses to the degree the United States does, and China itself does not have barriers against dealing with us based on the same kind of philosophical difference.

I am not saying that we do not need to be cautious that China is a Communist country. We do, but we need to be able to distinguish between countries that are Communist. China is not the Soviet Union. And we have to be able to look at China as an individual country, and deal with it on its own terms.

I will conclude with Mary Locke's question, which has to do with Public Law 480 and the Foreign Assistance Act. I think these are evidence of this particular problem that we have with communism which stands in the way of our political relations and therefore our economic relations with China in general. As far as waiting until there is a specific problem, that implies that we necessarily would want to give China say, project aid, which is not necessarily the case. There are problems which the Government faces every week in dealing with the Chinese on these issues. There are international conferences to which we can invite all countries except for China, areas in which we could get a lot of information from the Chinese and work well with the Chinese, which we are prohibited from doing because of this legislation.

So I think we need to consider the different levels on which we deal with the Chinese in addressing these problems.

Mr. SUTTER. Thank you very much. I might add that Ruth, although she is no longer with the State Department, comes at this with several years of experience working in economic affairs with China at the Department of State.

Mr. Heginbotham has a brief question.

Mr. HEGINBOTHAM. If I could, not so much a question as a brief comment that touches on a number of things here.

Mr. SUTTER. If it is agreeable to others, this will be the final comment, and then we will have to close, in the interest of time.

Mr. HEGINBOTHAM. I did not mean to preempt that honor.

We talked about aid and these particular bits of legislation. There is one program that we really should pay a lot more initial attention to, because it happens to fall within a provision of law under which China has been designated as a friendly country, one of a few relatively narrow little windows. This is the trade and development program which provides grant feasibility study money. It has a number of advantages in terms of the policy context point that Ruth has raised, for example, and that is that this program is to provide entree and facilitate a role for the private sector in trade and investment activities.

This program is underutilized, underled, under everything, but it has potential that really ought to be reinforced, particularly for some of the advantages it offers with regard to China. It is grant money that can be provided in very small amounts to provide the opportunity for feasibility studies in the areas where we can at one and the same time contribute to China's development and contribute more entree and more of a role for American business.

So it is something that ought to be given special study, again in the context that Mary raised, and that Robert Cornell and others have identified.

Mr. SUTTER. I want to thank our participants for their patience and for their very useful insights into this very important question, and I want to thank you, the audience, for your consideration as well.

This session is closed.

[Whereupon, at 11:45 a.m., the workshop concluded.]